Internal Revenue
# bulletin

Bulletin No. 1999–5
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## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

### INCOME TAX

**Rev. Rul. 99–7, page 4.**
Deductibility of daily transportation expenses. This ruling provides the rules for determining whether daily transportation expenses incurred by a taxpayer in going between the taxpayer's residence and a work location are deductible business expenses under section 162(a) of the Code.

**T.D. 8791, page 7.**
Final regulations under section 664 of the Code relate to charitable remainder trusts and to special valuation rules for transfers of interests in trusts.

**T.D. 8797, page 5.**
Final regulations relate to start-up expenditures for active trades or businesses under section 195 of the Code.

**T.D. 8805, page 14.**
Final regulations and temporary regulations under sections 865 and 904 of the Code relate to the allocation of loss recognized on the disposition of stock and other personal property and the computation of the foreign tax credit limitation.

### EMPLOYEE PLANS

**Rev. Proc. 99–13, page 52.**
Tax-sheltered annuities; operational defects; closing agreements. A program whereby tax-sheltered annuities within the meaning of section 403(b) of the Code may correct certain operational defects or enter into closing agreements with the Service is set forth. Rev. Proc. 98–22 modified and amplified.

### EXEMPT ORGANIZATIONS

**Announcement 99–10, page 63.**
A list is given of organizations now classified as private foundations.

### ADMINISTRATIVE

**Rev. Proc. 99–14, page 56.**
Automobile owners and lessees. This procedure provides owners and lessees of passenger automobiles (including electric automobiles) with tables detailing the limitations on depreciation deductions for automobiles first placed in service during calendar year 1999 and the amounts to be included in income for automobiles first leased during calendar year 1999. In addition, this procedure provides the maximum allowable value of employer-provided automobiles first made available to employees for personal use in calendar year 1999 for which the vehicle cents-per-mile valuation rule provided under section 1.61–21(e) of the Income Tax Regulations may be applicable.

**Notice 99–8, page 26.**
This notice announces that the Service will make certain changes to the section 1441 withholding regulations, and provides the text of a model qualified intermediary withholding agreement.

**Announcement 99–11, page 64.**
This announcement provides guidance for 1997–1998 fiscal year filers of the 1997 Schedule D for Forms 1040, 1041, 1065, and 1120S.

**Announcement 99–12, page 65.**
Rev. Proc. 98–44, 1998–32 I.R.B. 11, Specifications for Filing Forms 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically/Electronically, is corrected.

Finding Lists begin on page 67.
Index for January begins on page 69.

Department of the Treasury
**Internal Revenue Service**

# Mission of the Service

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

# Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

# Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

### Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### Part IV.—Items of General Interest.

With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a quarterly and semiannual basis, and are published in the first Bulletin of the succeeding quarterly and semiannual period, respectively.



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# Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

## Section 162.—Trade or Business Expenses

*26 CFR 1.162–2: Traveling expenses.*
*(Also sections 262; 1.262–1.)*

**Deductibility of daily transportation expenses.** This ruling provides the rules for determining whether daily transportation expenses incurred by a taxpayer in going between the taxpayer's residence and a work location are deductible business expenses under section 162(a) of the Code.

## Rev. Rul. 99–7

ISSUE

Under what circumstances are daily transportation expenses incurred by a taxpayer in going between the taxpayer's residence and a work location deductible under § 162(a) of the Internal Revenue Code?

LAW AND ANALYSIS

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 262, however, provides that no deduction is allowed for personal, living, or family expenses.

A taxpayer's costs of commuting between the taxpayer's residence and the taxpayer's place of business or employment generally are nondeductible personal expenses under §§ 1.162–2(e) and 1.262–1(b)(5) of the Income Tax Regulations. However, the costs of going between one business location and another business location generally are deductible under § 162(a). Rev. Rul. 55–109, 1955–1 C.B. 261.

Section 280A(c)(1)(A) (as amended by § 932 of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 881, effective for taxable years beginning after December 31, 1998) provides, in part, that a taxpayer may deduct expenses for the business use of the portion of the taxpayer's personal residence that is exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer. (In the case of an employee, however, such expenses are deductible only if the exclusive and regular use of the portion of the residence is for the convenience of the employer.) In *Curphey v. Commissioner,* 73 T.C. 766 (1980), the Tax Court held that daily transportation expenses incurred in going between an office in a taxpayer's residence and other work locations were deductible where the home office was the taxpayer's principal place of business within the meaning of § 280A(c)(1)(A) for the trade or business conducted by the taxpayer at those other work locations. The court stated that "[w]e see no reason why the rule that local transportation expenses incurred in travel between one business location and another are deductible should not be equally applicable *where the taxpayer's principal place of business with respect to the activities involved is his residence.*" 73 T.C. at 777–778 (emphasis in original). Implicit in the court's analysis in *Curphey* is that the deductibility of daily transportation expenses is determined on a business-by-business basis.

Rev. Rul. 190, 1953–2 C.B. 303, provides a limited exception to the general rule that the expenses of going between a taxpayer's residence and a work location are nondeductible commuting expenses. Rev. Rul. 190 deals with a taxpayer who lives and ordinarily works in a particular metropolitan area but who is not regularly employed at any specific work location. In such a case, the general rule is that daily transportation expenses are not deductible when paid or incurred by the taxpayer in going between the taxpayer's residence and a *temporary* work site *inside* that metropolitan area because that area is considered the taxpayer's regular place of business. However, Rev. Rul. 190 holds that daily transportation expenses are deductible business expenses when paid or incurred in going between the taxpayer's residence and a *temporary* work site *outside* that metropolitan area.

Rev. Rul. 90–23, 1990–1 C.B. 28, distinguishes Rev. Rul. 190 and holds, in part, that, for a taxpayer who has one or more regular places of business, daily transportation expenses paid or incurred in going between the taxpayer's residence and *temporary* work locations are deductible business expenses under § 162(a), regardless of the distance.

Rev. Rul. 94–47, 1994–2 C.B. 18, amplifies and clarifies Rev. Rul. 190 and Rev. Rul. 90–23, and provides several rules for determining whether daily transportation expenses are deductible business expenses under § 162(a). Under Rev. Rul. 94–47, a taxpayer generally may not deduct daily transportation expenses incurred in going between the taxpayer's residence and a work location. A taxpayer, however, may deduct daily transportation expenses incurred in going between the taxpayer's residence and a *temporary* work location *outside* the metropolitan area where the taxpayer lives and normally works. In addition, Rev. Rul. 94–47 clarifies Rev. Rul. 90–23 to provide that a taxpayer must have at least one regular place of business located "away from the taxpayer's residence" in order to deduct daily transportation expenses incurred in going between the taxpayer's residence and a *temporary* work location in the same trade or business, regardless of the distance. In this regard, Rev. Rul. 94–47 also states that the Service will not follow the decision in *Walker v. Commissioner,* 101 T.C. 537 (1993). Finally, Rev. Rul. 94–47 amplifies Rev. Rul. 190 and Rev. Rul. 90–23 to provide that, if the taxpayer's residence is the taxpayer's principal place of business within the meaning of § 280A(c)(1)(A), the taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and another work location in the same trade or business, regardless of whether the other work location is regular or *temporary* and regardless of the distance.

For purposes of both Rev. Rul. 90–23 and Rev. Rul. 94–47, a *temporary* work location is defined as any location at which the taxpayer performs services on an irregular or short-term (*i.e.*, generally a matter of days or weeks) basis. However, for purposes of determining whether daily transportation expense allowances and per diem travel allowances for meal and lodging expenses are subject to income tax withholding under § 3402, Rev. Rul. 59–371, 1959–2 C.B. 236, provides a 1-year standard to determine whether a work location is *temporary*. Similarly, for purposes of determining the deductibility of travel away-from-home expenses under § 162(a)(2), Rev. Rul. 93–86, 1993–2 C.B. 71, generally provides a 1-year standard to determine whether a work location will be treated as *temporary*.

The Service has reconsidered the definition of a *temporary* work location in Rev. Rul. 90–23 and Rev. Rul. 94–47, and will replace the "irregular or short-term (*i.e.*, generally a matter of days or weeks) basis" standard in those rulings with a 1-year standard similar to the rules set forth in Rev. Rul. 59–371 and Rev. Rul. 93–86.

If an office in the taxpayer's residence satisfies the principal place of business requirements of § 280A(c)(1)(A), then the residence is considered a business location for purposes of Rev. Rul. 90–23 or Rev. Rul. 94–47. In these circumstances, the daily transportation expenses incurred in going between the residence and other work locations in the same trade or business are ordinary and necessary business expenses (deductible under § 162(a)). *See Curphey; see also Wisconsin Psychiatric Services v. Commissioner,* 76 T.C. 839 (1981). In contrast, if an office in the taxpayer's residence does not satisfy the principal place of business requirements of § 280A(c)(1)(A), then the business activity there (if any) is not sufficient to overcome the inherently personal nature of the residence and the daily transportation expenses incurred in going between the residence and regular work locations. In these circumstances, the residence is not considered a business location for purposes of Rev. Rul. 90–23 or Rev. Rul. 94–47, and the daily transportation expenses incurred in going between the residence and regular work locations are personal expenses (nondeductible under §§ 1.162–2(e) and 1.262–1(b)(5)). *See Green v. Commissioner,* 59 T.C. 456 (1972); *Fryer v. Commissioner,* T.C. M. 1974–77.

For purposes of determining the deductibility of travel-away-from-home expenses under §162(a)(2), Rev. Rul. 93–86 defines "home" as the "taxpayer's regular or principal (if more than one regular) place of business." *See Daly v. Commissioner,* 72 T.C. 190 (1979), aff'd, 662 F.2d 253 (4th Cir. 1981); *Flowers v. Commissioner,* 326 U.S. 465 (1946), 1946–1 C.B. 57.

HOLDING

In general, daily transportation expenses incurred in going between a taxpayer's residence and a work location are nondeductible commuting expenses. However, such expenses are deductible under the circumstances described in paragraph (1), (2), or (3) below.

(1) A taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a *temporary* work location *outside* the metropolitan area where the taxpayer lives and normally works. However, unless paragraph (2) or (3) below applies, daily transportation expenses incurred in going between the taxpayer's residence and a *temporary* work location *within* that metropolitan area are nondeductible commuting expenses.

(2) If a taxpayer has one or more regular work locations away from the taxpayer's residence, the taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a *temporary* work location in the same trade or business, regardless of the distance. (The Service will continue not to follow the *Walker* decision.)

(3) If a taxpayer's residence is the taxpayer's principal place of business within the meaning of § 280A(c)(1)(A), the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is *regular* or *temporary* and regardless of the distance.

For purposes of paragraphs (1), (2), and (3), the following rules apply in determining whether a work location is *temporary.* If employment at a work location is realistically expected to last (and does in fact last) for 1 year or less, the employment is *temporary* in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is *not temporary*, regardless of whether it actually exceeds 1 year. If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes, and will be treated as *not temporary* after that date.

The determination that a taxpayer's residence is the taxpayer's principal place of business within the meaning of § 280A(c)(1)(A) is not necessarily determinative of whether the residence is the taxpayer's tax home for other purposes, including the travel-away-from-home deduction under § 162(a)(2).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 190 and Rev. Rul. 59–371 are obsoleted. Rev. Rul. 90–23 and Rev. Rul 94–47 are modified (regarding the definition of *temporary* work location) and superseded. With respect to issues (2) and (3) in Rev. Rul. 90–23 (regarding the gross income and employment tax treatment of reimbursements for employee daily transportation expenses), see § 1.62–2 regarding reimbursements in general, and Rev. Proc. 97-58 (particularly sections 3, 9, and 10), 1997–2 C.B. 587 (or any successor), regarding reimbursements using the optional business standard mileage rate. Rev. Rul. 93–86 is distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Edwin B. Cleverdon of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Cleverdon at (202) 622-4920 (not a toll-free call).

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## Section 195.—Start-up Expenditures

*26 CFR 1.195–1: Election to amortize start-up expenditures.*

## T.D. 8797

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

## Election to Amortize Start-Up Expenditures for Active Trades or Businesses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning start-up expenditures for active trades or businesses under section 195. These regulations are necessary to provide rules and procedures for electing to amortize start-up expenditures under section 195. They affect all taxpayers wishing to amortize start-up expenditures under section 195.

DATES: *Effective Date:* These regulations are effective December 17, 1998.

*Applicability Date:* For the date of applicability of these regulations, see §1.195–1(d).

FOR FURTHER INFORMATION CONTACT: David Selig, (202) 622-3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

*Paperwork Reduction Act*

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1582.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from .10 hours to .50 hours, depending on individual circumstances, with an estimated average of .25 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

*Background*

Section 195 was added to the Internal Revenue Code of 1954 by section 102 of the Miscellaneous Revenue Act of 1980, and was amended by section 94 of the Tax Reform Act of 1984.

Section 195 generally provides that no deduction is allowed for start-up expenditures unless the taxpayer elects to amortize the expenditures. Under section 195(b)(1), if the taxpayer elects to amortize start-up expenditures, the expenditures are amortizable over a period of not less than 60 months beginning with the month in which the active trade or business begins. Section 195(d) provides that an election to amortize start-up expenditures must be made not later than the time prescribed by law for filing the return for the taxable year in which the active trade or business begins (including extensions thereof).

On January 13, 1998, the IRS published a notice of proposed rulemaking [REG–209373–81, 1998–14 I.R.B. 26] in the **Federal Register** (63 F.R. 1933) proposing amendments to the Income Tax Regulations (26 CFR part 1) concerning the election to amortize start-up expenditures under section 195 of the Internal Revenue Code. A public hearing was scheduled for June 2, 1998, pursuant to a notice of public hearing published simultaneously with the notice of proposed rulemaking. No one requested to speak at the public hearing, therefore, no public hearing was held. Written comments responding to the notice were received. After consideration of all of the comments, the proposed regulations are adopted as revised by this Treasury decision.

*Explanation of Revisions and Discussion of Comments*

The proposed regulations provide that an election to amortize start-up expenditures is made by attaching a statement to the taxpayer's income tax return. The income tax return and statement must be filed not later than the date prescribed by law for filing the income tax return (including any extensions of time) for the taxable year in which the active trade or business begins. Thus, a taxpayer may file an election for any taxable year prior to the year in which the taxpayer's active trade or business begins, and such election will become effective in the month of the year in which the taxpayer's active trade or business begins.

One commentator suggested that the provision in the proposed regulations permitting the filing of a revised statement to include any start-up expenditures not included in the taxpayer's original election statement appears to endorse the practice of those taxpayers who file elections listing token or zero start-up expenditures on the election statement and subsequently attempt to increase the amount subject to amortization by expenditures that taxpayers have been unsuccessful in maintaining as expansion costs. The provision is not designed to permit a taxpayer to revise the election statement to include start-up expenditures omitted by reason of the taxpayer's claim on the taxpayer's return that the expenditures are expansion costs. Accordingly, the regulations have been clarified to provide that the election statement may not be revised to include expenditures that a taxpayer has treated on the taxpayer's tax return in a manner inconsistent with their treatment as start-up expenditures.

Another commentator suggested that a separate statement to make the election under section 195 should not be required for small businesses, but rather a check-the-box election should be provided. A separate statement is necessary to ensure that the expenses listed therein are properly characterized as start-up expenditures, and that amortization of the start-up expenditures will begin and end at the proper times. The statement is simple to complete and the time to prepare the statement is minimal. Accordingly, the final regulations retain the requirement that a separate statement with the requisite information be attached to the taxpayer's return.

*Special Analyses*

has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant impact on a substantial number of small entities. This certification is based upon the fact that the time required to prepare and file the election statement is minimal and will not have a significant impact on those small entities that choose to make the election. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

*Drafting Information*

The principal author of these regulations is David Selig, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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*Adoption of Amendments to the Regulations*

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.195–1 is added to read as follows:

*§1.195–1 Election to amortize start-up expenditures.*

(a) *In general.* Under section 195(b), a taxpayer may elect to amortize start-up expenditures (as defined in section 195(c)(1)). A taxpayer who elects to amortize start-up expenditures must, at the time of the election, select an amortization period of not less than 60 months, beginning with the month in which the active trade or business begins. The election applies to all of the taxpayer's start-up expenditures with respect to the trade or business. The election to amortize start-up expenditures is irrevocable, and the amortization period selected by the taxpayer in making the election may not subsequently be changed.

(b) *Time and manner of making election.* The election to amortize start-up expenditures under section 195 shall be made by attaching a statement containing the information described in paragraph (c) of this section to the taxpayer's return. The statement must be filed no later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the active trade or business begins. The statement may be filed with a return for any taxable year prior to the year in which the taxpayer's active trade or business begins, but no later than the date prescribed in the preceding sentence. Accordingly, an election under section 195 filed for any taxable year prior to the year in which the taxpayer's active trade or business begins (and pursuant to which the taxpayer commenced amortizing start-up expenditures in that prior year) will become effective in the month of the year in which the taxpayer's active trade or business begins.

(c) *Information required.* The statement shall set forth a description of the trade or business to which it relates with sufficient detail so that expenses relating to the trade or business can be identified properly for the taxable year in which the statement is filed and for all future taxable years to which it relates. The statement also shall include the number of months (not less than 60) over which the expenditures are to be amortized, and to the extent known at the time the statement is filed, a description of each start-up expenditure incurred (whether or not paid) and the month in which the active trade or business began (or was acquired). A revised statement may be filed to include any start-up expenditures not included in the taxpayer's original election statement, but the revised statement may not include any expenditures for which the taxpayer had previously taken a position on a return inconsistent with their treatment as start-up expenditures. The revised statement may be filed with a return filed after the return that contained the election.

(d) *Effective date.* This section applies to elections filed on or after December 17, 1998.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (c) is amended by adding an entry to the table in numerical order to read as follows:

*§602.101 OMB Control numbers.*

* * * * *

(c) * * *

| CFR part or section where identified and described | Current OMB control No. |
|---|---|
| * * * * * | |
| 1.195–1 | 1545–1582 |
| * * * * * | |

Bob Wenzel,
*Deputy Commissioner of Internal Revenue.*

Donald C. Lubick,
*Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on December 16, 1998, 8:45 a.m., and published in the issue of the Federal Register for December 17, 1998, 63 F.R. 69554)

## Section 262.—Personal, Living, and Family Expenses

*26 CFR 1.262–1: Personal, living, and family expenses.*

For the rules to determine whether daily transportation expenses incurred by a taxpayer are deductible business expenses under § 162(a), see Rev. Rul. 99–7, page 4.

## Section 664.—Charitable Remainder Trusts

*26 CFR 1.664–1: Charitable remainder trusts.*

T.D. 8791

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 25, and 602

## Guidance Regarding Charitable Remainder Trusts and Special Valuation Rules for Transfers of Interests in Trusts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to charitable remainder trusts and to special valuation rules for transfers of interests in trusts. The final regulations provide additional guidance regarding charitable remainder trusts. The final regulations affect charitable remainder trusts and their beneficiaries.

DATES: *Effective date:* These regulations are effective December 10, 1998.

*Applicability dates:* For dates of applicability of these regulations, see the explanations under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Mary Beth Collins or Jeff Erickson, (202) 622-3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

*Paperwork Reduction Act*

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1536. Responses to this collection of information are required to allow taxpayers alternative means of valuing a charitable remainder trust's unmarketable assets.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from .25 to .75 hours, depending on individual circumstances, with an estimated average of .5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

*Background*

On April 18, 1997, the IRS published in the **Federal Register** (62 F.R. 19072) a notice of proposed rulemaking (REG–209823–96, 1997–1 C.B. 763) regarding sections 664 and 2702. Comments responding to the proposed regulations were received, and a public hearing was held on November 18, 1997. After considering the comments received and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision.

*Explanation of Provisions*

This document amends 26 CFR parts 1 and 25 to provide additional rules under sections 664 and 2702. Section 664 contains the rules for charitable remainder trusts (CRTs). In general, a CRT provides for a specified periodic distribution to one or more beneficiaries (at least one of whom is a noncharitable beneficiary) for life or for a term of years with an irrevocable remainder interest held for the benefit of charity.

There are two types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT). A CRAT pays a sum certain at least annually to the beneficiaries (the annuity amount). A CRUT pays a unitrust amount at least annually to the beneficiaries. Generally, the unitrust amount is a fixed percentage of the net fair market value of the CRUT's assets valued annually (fixed percentage CRUT). The unitrust amount can instead be calculated under one of two income exception methods (income exception CRUT). Under the first method, the unitrust amount is the lesser of the fixed percentage amount or the trust's annual net income (net income method). Under the second method, the unitrust amount is determined under the net income method plus any amount of income that exceeds the current year's fixed percentage amount to make up for any shortfall in payments from prior years when the trust income was less than the fixed percentage amount (NIMCRUT method). The shortfall in payments from prior years is commonly referred to as the "make-up amount."

The revisions to the proposed regulations are discussed below.

I. *Flip Unitrusts*

A. Triggering Events

The proposed regulations provide specific rules for when a trust may convert from one of the income exception methods of computing the unitrust amount to the fixed percentage method (flip unitrust). The proposed rule was designed for taxpayers who ultimately wanted the unitrust amount to be computed on the fixed percentage method but funded the trust with unmarketable assets that generate little annual income. A number of commentators agreed with the policy underlying the proposed rule. Some commentators requested that we permit flip unitrusts for all income exception CRUTs regardless of the marketability of the trust assets. Other commentators suggested that the final regulations clarify whether the proposed rule was a safe harbor or the exclusive circumstance for which a flip unitrust would be permitted.

In response, the final regulations expand the availability of the flip unitrust to certain other situations that the IRS and Treasury believe are consistent with the legislative history indicating that a trustee should not have discretion to change the method used to calculate the unitrust amount. H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 296 (1969), 1969–3 C.B. 644, 655.

The final regulations allow the governing instrument of a CRUT to provide that the CRUT will convert once from one of the income exception methods to the fixed percentage method for calculating the unitrust amount if the date or event triggering the conversion is outside the control of the trustees or any other persons. The final regulations include examples of permissible and impermissible triggering events. For example, permissible triggering events with respect to any individual include marriage, divorce, death, or birth of a child. Also, the sale of an unmarketable asset such as real estate is a permissible triggering event. Examples of impermissible triggering events include the sale of marketable assets and a request from the unitrust recipient or the unitrust recipient's financial advisor that the trust convert to the fixed percentage method.

The final regulations also provide that the conversion to the fixed percentage method occurs at the beginning of the taxable year that immediately follows the taxable year in which the triggering date or event occurs. Any make-up amount described in section 664(d)(3)(B) is forfeited when the trust converts to the fixed percentage method.

The proposed regulations define unmarketable assets as assets other than cash, cash equivalents, or marketable securities (within the meaning of section 731(c)). Commentators asked for clarification of the term *unmarketable assets* and recommended changing the scope of this class of assets. In response, the final regulations define unmarketable assets as assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and unregistered securities for which there is no available exemption permitting public sale.

Commentators requested that the final regulations permit conversions from the fixed percentage method to one of the income exception methods and conversions from a CRAT to a CRUT. The flip unitrust allowed in the final regulations is the only type of permissible conversion. Thus, a CRAT cannot convert to a CRUT without losing its status as a CRT. Similarly, a CRUT using the fixed percentage method cannot convert to an income exception method without losing its status as a CRT.

B. Effective Date and Transitional Rules

The rules for flip unitrusts are effective for CRUTs created on or after December 10, 1998. The proposed regulations allowed reformations in limited circumstances. In response to comments, the final regulations expand the circumstances in which reformation is available. The final regulations allow income exception CRUTs to be reformed to add provisions allowing a conversion to the fixed percentage method provided the triggering event does not occur in a year prior to the year in which the court issues the order reforming the trust. Adding the conversion provisions will not cause the CRUT to fail to function exclusively as a CRT and will not be an act of self-dealing under section 4941 if the trustee initiates legal proceedings to reform the trust by June 8, 1999.

II. *Time for Paying the Annuity Amount or the Unitrust Amount*

The proposed regulations provide that the payment of the annuity amount or the unitrust amount determined under the fixed percentage method must be made by the close of the taxable year in which it is due. The rules were proposed in response to abuses associated with the use of accelerated CRTs described in Notice 94–78 (1994–2 C.B. 555). After receiving a significant number of comments on the proposed rules, the IRS issued Notice 97–68 (1997–48 I.R.B. 11), which provided guidance on complying with the proposed rules for the 1997 taxable year.

One commentator recommended applying the proposed rules only to trusts created after the date the final regulations are published. Another commentator suggested adopting the rules in Notice 97–68 for all trusts created after a certain date. Although recent legislative changes have reduced the potential tax benefits of accelerated CRTs, the IRS and Treasury continue to be concerned about the potential abuse of the post-year-end grace period to produce a tax-free return of appreciation in the assets contributed to a CRAT or a fixed percentage CRUT. Therefore, the final regulations adopt rules similar to those in Notice 97–68 with certain modifications. The rules are effective for taxable years ending after April 18, 1997.

For CRATs and fixed percentage CRUTs, the annuity or unitrust amount may be paid within a reasonable time after the close of the year for which it is due if (a) the character of the annuity or unitrust amount in the recipient's hands is income under section 664(b)(1), (2), or (3); and/or (b) the trust distributes property (other than cash) that it owned as of the close of the taxable year to pay the annuity or unitrust amount and the trustee elects on Form 5227, "Split-Interest Trust Information Return," to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due. In addition, for CRATs and fixed percentage CRUTs that were created before December 10, 1998, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due if the percentage used to calculate the annuity or unitrust amount is 15 percent or less.

III. *Appraising Unmarketable Assets*

Under section 664(d)(2)(A), a CRUT must value its assets annually. The proposed regulations provide that, if a CRT holds unmarketable assets and the only trustee is the grantor, a noncharitable beneficiary, or a related or subordinate party to the grantor or the noncharitable beneficiary within the meaning of section 672(c) and the applicable regulations, the trustee must value those assets using a *current qualified appraisal,* as defined in §1.170A–13(c)(3), from a *qualified appraiser,* as defined in §1.170A–13(c)(5).

The final regulations follow the proposed regulations and provide that the trust's unmarketable assets must be valued by an independent trustee, or by a qualified appraisal from a qualified appraiser. The proposed regulations define an independent trustee as a person who is not the grantor, a noncharitable beneficiary or a related or subordinate party to the grantor, or the noncharitable beneficiary within the meaning of section 672(c) and the applicable regulations. The final regulations add the grantor's spouse to the list of persons to whom an independent trustee cannot be related or subordinate. A co- trustee who is an independent trustee may value the trust's unmarketable assets.

Finally, in response to comments, the final regulations define unmarketable assets as assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and unregistered securities for which there is no available exemption permitting public sale.

The rules for valuing unmarketable assets are effective for trusts created on or after December 10, 1998.

IV. *Application of Section 2702 to Certain CRUTs*

Under the proposed regulations, unitrust interests in an income exception CRUT that are retained by the donor or any applicable family member will be valued at zero when a noncharitable beneficiary of the trust is someone other than (1) the donor, (2) the donor's U.S. citizen spouse, or (3) both the donor and the donor's U.S. citizen spouse. Commentators stated that income exception CRUTs without a make-up provision should be exempt from section 2702. The IRS and Treasury believe that, in addition to the NIMCRUT method, the net income method can be used to circumvent the intent of section 2702. Therefore, the final regulations do not exempt from section 2702 CRUTs that use only the net income method.

Commentators also stated that the proposed rule encompassed other transfers that section 2702 was not intended to include. A commentator noted that the proposed rule would value a transferor's interest at zero even though the transferor merely retained a secondary life estate. The final regulations clarify that section 2702 will not apply when there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests.

Commentators also asked whether section 2702 may apply to flip unitrusts. The potential abuse associated with income exception CRUTs also exists with flip unitrusts. Therefore, under the final regulations, section 2702 applies to a flip unitrust if the CRUT does not fall within one of the exemptions.

V. *Prohibition on Allocating Precontribution Gain to Trust Income and Make-up Amount as a Liability*

The proposed regulations clarify that the proceeds from the sale of an income exception CRUT's assets, at least to the extent of the fair market value of the assets when contributed to the trust, must be allocated to trust principal. Some commentators stated that the rule is inconsistent with the rule concerning income under section 643(b). Other commentators questioned whether the make-up amount under the NIMCRUT method should be treated as a liability when valuing the trust's assets.

The final regulations maintain the prohibition on allocating precontribution gain to trust income for an income exception CRUT. However, the governing instrument, if permitted under applicable local law, may allow the allocation of post-contribution capital gains to trust income. Taxpayers do not have to treat the make-up amount as a liability when valuing the assets of a NIMCRUT.

VI. *Example Illustrating Rule for Characterizing Distributions from CRUTs*

The proposed regulations contain an example of how the ordering rule under section 664(b) operates when the unitrust amount is computed under an income exception method. No comments were received on this example. Thus, the final regulations adopt the example without any changes.

*Effect on Other Documents*

Notice 97–68 (1997–48 I.R.B. 11) is obsolete as of December 10, 1998.

*Special Analyses*

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f), the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

*Drafting Information*

The principal authors of these regulations are Mary Beth Collins and Jeff Erickson, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from offices of the IRS and Treasury Department participated in their development.

* * * * *

*Adoption of Amendments to the Regulations*

Accordingly, CFR parts 1, 25, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.664–1, paragraphs (a)(7) and (d)(1)(iii) are added, and paragraph (f)(4) is added following the concluding text of paragraph (f)(3) to read as follows:

*§1.664–1 Charitable remainder trusts.*

(a) * * *

(7) *Valuation of unmarketable assets*—(i) *In general.* If unmarketable assets are transferred to or held by a trust, the trust will not be a trust with respect to which a deduction is available under section 170, 2055, 2106, or 2522, or will be treated as failing to function exclusively as a charitable remainder trust unless, whenever the trust is required to value such assets, the valuation is—

(*a*) Performed exclusively by an independent trustee; or

(*b*) Determined by a *current qualified appraisal*, as defined in §1.170A–13(c)-(3), from a *qualified appraiser,* as defined in §1.170A–13(c)(5).

(ii) *Unmarketable assets*. Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

(iii) *Independent trustee.* An independent trustee is a person who is not the grantor of the trust, a noncharitable beneficiary, or a related or subordinate party to the grantor, the grantor's spouse, or a noncharitable beneficiary (within the meaning of section 672(c) and the applicable regulations).

* * * * *

(d) * * * (1) * * *

(iii) *Example.* The following example illustrates the application of this paragraph (d)(1):

*Example.* (i) *X* is a charitable remainder unitrust described in section 664(d)(2) and (3). The annual unitrust amount is the lesser of the amount of trust income, as defined in §1.664–3(a)(1)(i)(b), or six percent of the net fair market value of the trust assets valued annually. The net fair market value of the trust assets on the valuation date in 1996 is $150,000. During 1996, *X* has $7,500 of income after allocating all expenses. All of *X*'s income for 1996 is tax-exempt income. At the end of 1996, *X*'s ordinary income for the current taxable year and undistributed ordinary income for prior years are both zero; *X*'s capital gain for the current taxable year is zero and undistributed capital gain for prior years is $30,000; and *X*'s tax-exempt income for the current year is $7,500 and undistributed tax-exempt income for prior years is $2,500.

(ii) Because the trust income of $7,500 is less than the fixed percentage amount of $9,000, the unitrust amount for 1996 is $7,500. The character of that amount in the hands of the recipient of the unitrust amount is determined under section 664(b). Because the unitrust amount is less than *X*'s undistributed capital gain income, the recipient of the unitrust amount treats the distribution of $7,500 as capital gain. At the beginning of 1997, *X*'s undistributed capital gain for prior years is reduced to $22,500, and *X*'s undistributed tax-exempt income is increased to $10,000.

* * * * *

(f) * * *

(4) *Valuation of unmarketable assets.* The rules contained in paragraph (a)(7) of this section are applicable for trusts created on or after December 10, 1998. A trust in existence as of December 10, 1998, whose governing instrument requires that an independent trustee value the trust's unmarketable assets may be amended or reformed to permit a valuation method that satisfies the requirements of paragraph (a)(7) of this section for taxable years beginning on or after December 10, 1998.

* * * * *

Par. 3. In §1.664–2, paragraph (a)(1)(i) is revised to read as follows:

*§1.664–2 Charitable remainder annuity trust.*

(a) * * *

(1) * * * (i) *Payment of sum certain at least annually.* The governing instrument provides that the trust will pay a sum certain not less often than annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section.

(*a*) *General rule applicable to all trusts.* A trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire annuity amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(*1*) The trust distributes property (other than cash) that it owned at the close of the taxable year to pay the annuity amount; and

(*2*) The trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the annuity amount is due.

(*b*) *Special rule for trusts created before December 10, 1998.* In addition, to the circumstances described in paragraph (a)(1)(i)(a) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the sum certain to be paid each year as the annuity amount is 15 percent or less of the initial net fair market value of the property irrevocably passing in trust as determined for federal tax purposes.

(*c*) *Reasonable time.* For this paragraph (a)(1)(i), a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, "Split-Interest Trust Information Return," (including extensions) for the taxable year.

(*d*) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(a) of this section:

*Example.* *X* is a charitable remainder annuity trust described in section 664(d)(1) that was created after December 10, 1998. The prorated annuity amount payable from *X* for Year 1 is $100. The trustee does not pay the annuity amount to the recipient by the close of Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b)(2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the recipient of the annuity a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 annuity amount due for Year 1. The trust owned the asset at the end of Year 1. Under §1.664–1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under §1.664–1(d)(1), the character of the annuity amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(a) of this section.

(*e*) *Effective date.* This paragraph (a)(1)(i) is applicable for taxable years ending after April 18, 1997.

* * * * *

Par. 4. Section 1.664–3 is amended as follows:

1. Paragraphs (a)(1)(i)(*a*), (a)(1)(i)(*b*)(*1*), and (a)(1)(i)(*b*)(*2*) are revised.

2. Paragraphs (a)(1)(i)(*b*)(*3*), (a)(1)(i)(*b*)(*4*), (a)(1)(i)(*b*)(*5*), and (a)(1)(i)(*c*) through (a)(1)(i)(l) are added.

3. The third sentence of paragraph (a)(1)(iv) is revised.

The added and revised provisions read as follows:

*§1.664–3 Charitable remainder unitrust.*

(a) * * *

(1) * * * (i) * * * (a) *General rule.* The governing instrument provides that the trust will pay not less often than annually a fixed percentage of the net fair market

value of the trust assets determined annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section. This paragraph (a)(1)(i)(*a*) is applicable for taxable years ending after April 18, 1997.

(*b*) * * *

(*1*) The amount of trust income for a taxable year to the extent that such amount is not more than the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section.

(*2*) An amount of trust income for a taxable year that is in excess of the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section for such year to the extent that (by reason of paragraph (a)(1)(i)(*b*)(*1*) of this section) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(*3*) For this paragraph (a)(1)(i)(*b*), trust income means income as defined under section 643(b) and the applicable regulations.

(*4*) For this paragraph (a)(1)(i)(*b*), proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution.

(*5*) The rules in paragraphs (a)(1)(i)(*b*)-(*1*), (*2*), and (*3*) of this section are applicable for taxable years ending after

April 18, 1997, and the rule in paragraph (a)(1)(i)(*b*)(*4*) of this section is applicable for sales or exchanges that occur after April 18, 1997.

(c) *Combination of methods*. Instead of the amount described in paragraph (a)(1)(i)(*a*) or (*b*) of this section, the governing instrument may provide that the trust will pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section for an initial period and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust only if the governing instrument provides that—

(*1*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) of this section to the method prescribed in paragraph (a)(1)(i)(*a*) of this section is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons;

(*2*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) of this section to the method prescribed in paragraph (a)(1)(i)(*a*) of this section occurs at the beginning of the taxable year that immediately follows the taxable year during which the date or event specified under paragraph (a)(1)(i)(*c*)(*1*) of this section occurs; and

(*3*) Following the trust's conversion to the method described in paragraph (a)(1)(i)(*a*) of this section, the trust will pay at least annually to the permissible recipients the amount described only in paragraph (a)(1)(i)(*a*) of this section and not any amount described in paragraph (a)(1)(i)(*b*) of this section.

(*d*) *Triggering event.* For purposes of paragraph (a)(1)(i)(*c*)(*1*) of this section, a triggering event based on the sale of unmarketable assets as defined in §1.664–1(a)(7)(ii), or the marriage, divorce, death, or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other persons.

(*e*) *Examples.* The following examples illustrate the rules in paragraph (a)(1)-(i)(*c*) of this section. For each example, assume that the governing instrument of charitable remainder unitrust *Y* provides that *Y* will initially pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust and that the requirements of paragraphs (a)(1)(i)(*c*)(*2*) and (*3*) of this section are satisfied. The examples are as follows:

*Example 1. Y* is funded with the donor's former personal residence. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the trust sells the residence. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

*Example 2. Y* is funded with cash and an unregistered security for which there is no available exemption permitting public sale under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered on the earlier of the date when the stock is sold or at the time the restrictions on its public sale lapse or are otherwise lifted. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

*Example 3. Y* is funded with cash and with a security that may be publicly traded under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered when the stock is sold. *Y* does not provide for a combination of methods that satisfies the requirements of paragraph (a)(1)(i)(*c*) of this section because the sale of the publicly-traded stock is within the discretion of the trustee.

*Example 4. S* establishes *Y* for her granddaughter, *G*, when *G* is 10 years old. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which *G* turns 18 years old. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

*Example 5.* The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the donor is married. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

*Example 6.* The governing instrument of *Y* provides that if the donor divorces, the change in method for computing the annual unitrust amount will occur as of the first day of the year following the year of the divorce. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

*Example 7.* The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's first child is born. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

*Example 8.* The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's father dies. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

*Example 9.* The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's financial advisor determines that the beneficiary should begin receiving payments under the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

*Example 10.* The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary submits a request to the trustee that the trust convert to the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

(f) *Effective date*—(*1*) *General rule*. Paragraphs (a)(1)(i)(c), (d), and (e) of this section are applicable for charitable remainder trusts created on or after December 10, 1998.

(*2*) *General rule regarding reformations of combination of method unitrusts.* If a trust is created on or after December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust will qualify as a charitable remainder unitrust only if it is amended or reformed to use the initial method for computing the unitrust amount throughout the term of the trust, or is reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. If a trust was created before December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust may be reformed to use the initial method for computing the unitrust amount throughout the term of the trust without causing the trust to fail to function exclusively as a charitable remainder unitrust under §1.664–1(a)(4), or may be reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. Except as provided in paragraph (a)(1)(i)(*f*)(*3*) of this section, a qualified charitable remainder unitrust will not continue to qualify as a charitable remainder unitrust if it is amended or reformed to add a provision allowing a change in the method for calculating the unitrust amount.

(3) *Special rule for reformations of trusts that begin by June 8, 1999.* Notwithstanding paragraph (a)(1)(i)(*f*)(*2*) of this section, if a trust either provides for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section, or provides for payment of the unitrust amount under only the method prescribed in paragraph (a)(1)(i)(*b*) of this section, then the trust may be reformed to allow for a combination of methods permitted under paragraph (a)(1)(i)(*c*) of this section without causing the trust to fail to function exclusively as a charitable remainder unitrust under §1.664–1(a)(4) or to engage in an act of self-dealing under section 4941 if the trustee begins legal proceedings to reform by June 8, 1999. The triggering event under the reformed governing instrument may not occur in a year prior to the year in which the court issues the order reforming the trust, except for situations in which the governing instrument prior to reformation already provided for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section and the triggering event occurred prior to the reformation.

(*g*) *Payment under general rule for fixed percentage trusts.* When the unitrust amount is computed under paragraph (a)(1)(i)(*a*) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire unitrust amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(*1*) The trust distributes property (other than cash) that it owned at the close of the taxable year to pay the unitrust amount; and

(*2*) The trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the unitrust amount is due.

(*h*) *Special rule for fixed percentage trusts created before December 10, 1998.* When the unitrust amount is computed under paragraph (a)(1)(i)(a) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the fixed percentage to be paid each year as the unitrust amount is 15 percent or less of the net fair market value of the trust assets as determined under paragraph (a)(1)(iv) of this section.

(*i*) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(g) of this section:

*Example. X* is a charitable remainder unitrust that calculates the unitrust amount under paragraph (a)(1)(i)(a) of this section. *X* was created after December 10, 1998. The prorated unitrust amount payable from *X* for Year 1 is $100. The trustee does not pay the unitrust amount to the recipient by the end of the Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b)(2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the unitrust recipient a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 unitrust amount due for Year 1. The trust owned the asset at the end of Year 1. Under §1.664–1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under §1.664–1(d)(1), the character of the unitrust amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(*g*) of this section.

(*j*) *Payment under income exception.* When the unitrust amount is computed under paragraph (a)(1)(i)(b) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because payment of the unitrust amount is made after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year.

(*k*) *Reasonable time.* For paragraphs (a)(1)(i)(g), (h), and (j) of this section, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, "Split-Interest Trust Information Return," (including extensions) for the taxable year.

(*l*) *Effective date.* Paragraphs (a)(1)(i)-(g), (h), (i), (j), and (k) of this section are applicable for taxable years ending after April 18, 1997.

* * * * *

(iv) * * * If the governing instrument does not specify the valuation date or dates, the trustee must select such date or dates and indicate the selection on the first return on Form 5227, "Split-Interest Trust Information Return," that the trust must file. * * *

* * * * *

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 5. The authority citation for part 25 continues to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 6. In §25.2702–1, paragraph (c)(3) is revised to read as follows:

*§25.2702–1 Special valuation rules in the case of transfers of interests in trust.*

* * * * *

(c) * * *

(3) *Charitable remainder trust.* (i) For transfers made on or after May 19, 1997, a transfer to a pooled income fund described in section 642(c)(5); a transfer to a charitable remainder annuity trust described in section 664(d)(1); a transfer to a charitable remainder unitrust described in section 664(d)(2) if under the terms of the governing instrument the unitrust amount can be computed only under section 664(d)(2)(A); and a transfer to a charitable remainder unitrust if under the terms of the governing instrument the unitrust amount can be computed under section 664(d)(2) and (3) and either there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests, or the only permissible recipients of the unitrust amount are the transferor, the transferor's U.S. citizen spouse, or both the transferor and the transferor's U.S. citizen spouse.

(ii) For transfers made before May 19, 1997, a transfer in trust if the remainder interest in the trust qualifies for a deduction under section 2522.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In §602.101, paragraph (c) is amended by revising the entry for §1.664-1 to read as follows:

*§602.101 OMB Control numbers.*

* * * * *

(c) * * *

| CFR part or section where identified and described | Current OMB control No. |
|---|---|
| * * * * * | |
| 1.664–1 | 1545–1536 |
| * * * * * | |

Robert E. Wenzel,

*Deputy Commissioner of Internal Revenue.*

Approved December 1, 1998.

Donald C. Lubick,
*Assistant Secretary of the Treasury, (Tax Policy).*

(Filed by the Office of the Federal Register on December 9, 1998, 8:45 a.m., and published in the issue of the Federal Register for December 10, 1998, 63 F.R. 68188)

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## Section 865.—Source Rules for Personal Property Sales

*26 CFR 1.865–1T: Loss with respect to personal property other than stock (Temporary).*

### T.D. 8805

### DEPARTMENT OF THE TREASURY
### Internal Revenue Service
### 26 CFR Part 1

## Allocation of Loss with Respect to Stock and Other Personal Property; Application of Section 904 to Income Subject to Separate Limitations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary Income Tax Regulations relating to the allocation of loss recognized on the disposition of stock and other personal property and the computation of the foreign tax credit limitation. The loss allocation regulations primarily will affect taxpayers that claim the foreign tax credit and that incur losses with respect to personal property and are necessary to modify existing guidance with respect to loss allocation. The foreign tax credit limitation regulations will affect taxpayers claiming foreign tax credits that have passive income or losses and are necessary to modify existing guidance with respect to the computation of the limitation.

DATES: *Effective dates:* These regulations are effective January 11, 1999, except that §1.904–4(c)(2)(ii)(A) and (B) are effective March 12, 1999 and §1.904–4(c)(3)(iv) is effective December 31, 1998.

*Dates of applicability:* For dates of applicability of §§1.865–1T, 1.865–2, and 1.865–2T, see §§1.865–1T(f), 1.865–2(e), and 1.865–2T(e), respectively. For dates of applicability of §1.904–4(c), see §1.904–4(c)(2)(i).

FOR FURTHER INFORMATION CONTACT: Seth B. Goldstein, (202) 622-3810, regarding section 865(j); and Rebecca Rosenberg, (202) 622-3850, regarding section 904(d) (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

*Background*

On May 14, 1992, the IRS published a notice of proposed rulemaking in the **Federal Register** (REG–209527–92, formerly INTL–1–92 (1992–1 C.B. 1209), 57 F.R. 20660), proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 904(d). The regulations included proposed amendments to the grouping rules under §1.904–4(c)(3) for purposes of determining whether passive income is high taxed. The amendments were proposed to be effective for taxable years beginning after December 31, 1991. A public hearing was held on September 24, 1992, but no written or oral comments were received with respect to these provisions. These regulations are finalized as proposed. However, as described below, the effective date of the regulations has been modified.

On July 8, 1996, the IRS published proposed amendments (REG–209750–95, formerly INTL–4–95 (1996–2 C.B. 484), 61 F.R. 35696) to the Income Tax Regulations (26 CFR part 1) under sections 861, 865, and 904 of the Internal Revenue Code in the **Federal Register.** The regulations addressed the allocation of loss on the disposition of stock (§1.865–2) and other personal property (§1.865–1) and also contained proposed amendments to the grouping rules under §1.904–4(c). The proposed regulations generally allocate loss with respect to stock based upon the residence of the seller (reciprocal to gain), but allocate loss on other personal property based upon the income generated by the property. A public hearing was held on November 6, 1996, and several written comments were received. The written comments endorsed the regulations' general approach with respect to the allocation of stock loss. In addition, on June 18, 1997, the Tax Court held in International *Multifoods Corporation v. Commissioner,* 108 T.C. 579 (1997), that loss on the disposition of stock is generally allocated based on the residence of the seller, consistent with the approach of the proposed regulations. After consideration of all the comments, the regulations proposed by INTL–4–95 with respect to stock loss and with respect to the grouping rules are adopted as amended by this Treasury decision. The principal changes to these regulations, as well as the major comments and suggestions, are discussed below. An additional anti-abuse rule, not previously proposed, is issued as a proposed and temporary regulation.

The written comments criticized the proposed regulation concerning the allocation of loss on other personal property (§1.865–1). This proposed regulation is withdrawn and replaced with a new proposed and temporary regulation that is more consistent with the approach of the stock loss allocation rules. The new rules are issued as a temporary regulation because of the need for immediate guidance following the *International Multifoods* opinion.

*Explanation of Provisions*

*Section 1.861-8T(e)(8): Net Operating Loss*

Section 1.861–8T(e)(8) clarifies that a net operating loss deduction allowed under section 172 is allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

*Section 1.865–1T: Loss With Respect to Personal Property Other Than Stock*

Section 1.865–1T(a) provides the general rule that loss with respect to personal property is allocated in the same manner in which gain on the sale of the property would be sourced. Thus, for example, loss on the sale or worthlessness of a foreign bond held by a U.S. resident generally would be allocated against U.S. source income. Notice 89–58 (1989–1 C.B. 699), which addressed the allocation of loss with respect to certain bank loans, is revoked as inconsistent with this approach. Taxpayers may rely on the Notice for loss recognized prior to the effective date of the temporary regulations (see discussion of effective dates, below). Following the general rule, loss attributable to a foreign office of a U.S. resident is allocated against foreign source income where gain would be foreign source under the foreign branch rule of section 865(e)(1).

Section 1.865–1T(b) provides special rules of application. Loss on depreciable property generally is allocated based upon the allocation of depreciation deductions taken with respect to the property, consistent with the depreciation-recapture source rule of section 865(c)(1). Similarly, loss with respect to a contingent payment debt instrument subject to Reg. §1.1275–4(b) is allocated against interest income because gain on the instrument generally is treated as interest income.

Section 1.865–1T(c) provides exceptions from the reciprocal-to-gain rule. The regulations do not apply to certain financial products (to be addressed in a future guidance project), loss governed by section 988, inventory (which is not governed by section 865), or trade receivables and certain interest equivalents (which are governed by §1.861–9T(b)). When Prop. §1.863–3(h) (the global dealing sourcing regulation) is finalized, §1.865–1T will not apply to any loss sourced under that regulation. Loss attributable to accrued-but-unpaid interest income is allocated against interest income. Also, loss on a debt instrument is allocated against interest income to the extent the taxpayer did not amortize bond premium to the full extent permitted by the Code. Anti-abuse exceptions are also provided. Section 1.865–1T(c)(6)(i), which prevents taxpayers from manipulating loss allocation through related-party transfers, reorganizations, or similar transactions, and §1.865–1T(c)(6)(ii), which addresses offsetting positions, are similar to the anti-abuse rules previously proposed with respect to stock losses. In addition, section 1.865–1T(c)(6)(iii) has been included to prevent taxpayers from accelerating foreign source income with respect to property and claiming an offsetting U.S. loss.

The temporary regulations are effective for loss recognized on or after January 11, 1999. A taxpayer may apply the regulations, however, to loss recognized in any taxable year beginning on or after January 1, 1987, subject to certain conditions.

*Section 1.865–2: Stock Loss*

The proposed regulations issued in 1996 provide that generally loss with respect to stock is allocated to the residence of the seller, but contain three major exceptions: an exclusion for dispositions of portfolio stock and stock in regulated investment companies (RICs) and S corporations, a dividend recapture rule, and a consistency rule for certain dispositions of foreign affiliates. The final regulations modify these exceptions. The principal comments and changes to the regulations are discussed below.

*Section 1.865–2(a): General Rule for Allocation of Stock Loss*

Commentators criticized the exclusion of portfolio stock and RIC stock from the general residence-based rule, arguing that the rationale for residence-based allocation applies equally to these classes of stock. The final regulations eliminate the exception for portfolio stock and RIC stock.

In response to a comment, the final regulations clarify that §1.865–2 does not apply to stock that constitutes inventory.

The proposed regulations allocate loss recognized on the "sale or other disposition" of stock. Proposed §1.865–2(c)(2) provides that worthlessness giving rise to a deduction under section 165(g)(3) with respect to stock is treated as a disposition. Questions have been raised as to whether the regulations apply to other recognized losses that are not the result of a sale or disposition (for example, loss recognized under the mark-to-market rules of section 475). The final regulations are intended to apply to all recognized stock losses. To avoid confusion, the reference to sales or other dispositions has been deleted in the final regulations. The special reference to worthlessness deductions is therefore unnecessary and also has been deleted.

*Section 1.865–2(b)(1): Dividend Recapture Exception*

Some commentators questioned the dividend recapture rule of §1.865–2(b)(1) and suggested that the rule should be limited to cases in which the dividends were fully sheltered from U.S. tax by foreign tax credits or the taxpayer did not meet a minimum holding period. Others suggested that the two-year recapture period defined in §1.865–2(d)(5) of the proposed regulations should be shortened. Sections 1.865–2(b)(1)(i) and 1.865–2(d)(3) of the final regulations retain the two-year rule.

Section 1.865–2(b)(1)(iii) of the final regulations provides an exception from dividend recapture for passive-basket dividends. This new exception will exempt most portfolio investors (other than financial services entities) from the dividend recapture rule. The rule, which will reduce administrative burdens, reflects the fact that passive income is generally subject to residual U.S. tax and the high-tax kick-out of section 904(d)(2)(A)(iii)(III) limits the potential for cross-crediting in the passive basket, thus reducing the need for recapture. In addition, allocation of loss to the passive basket may lead to investment incentives that violate the policies underlying the passive basket. For example, where a loss allocated to the passive basket creates a separate limitation loss under section 904(f)(5) that reduces high-taxed income in other baskets, this creates an incentive in subsequent years for the taxpayer to earn low-taxed foreign passive income to utilize the foreign tax credits in the high-taxed basket (due to the recharacterization rules of section 904(f)(5)(C)).

Commentators also suggested alternatives to the de minimis rule of §1.865–2(b)(1)(ii), which exempts from recapture dividends that are less than 10 percent of the recognized loss. The proposed de minimis rule is retained in the final regulations. The de minimis rule is intended to exempt from recapture, as a matter of administrative convenience, dividends that are relatively insignificant in comparison to the loss.

Two commentators questioned why the dividend recapture rule and the definition of the recapture period in §1.865–2(d)(5) of the proposed regulations refer to realized, rather than recognized, loss. The wording was intended to avoid confusion over the application of the rule to loss that is deferred under section 267(f). The final regulation refers to "recognized" loss, but examples have been added in §1.865–2(b)(1)(iv) of the final regulations to illustrate the application of the dividend recapture rule in the context of section 267(f) and how the result differs in the context of a consolidated group.

*Proposed §1.865–2(b)(2): Consistency Rule*

Proposed §1.865–2(b)(2) requires a taxpayer to allocate loss on the sale of a foreign affiliate to passive-basket foreign source income if the taxpayer recognized foreign source gain under section 865(f) at any time during the 5-year period preceding the loss sale. Commentators criticized this rule as producing disproportionate results where the foreign source gain is small in comparison to the subsequent loss. Furthermore, even where the gain and loss are of similar magnitude, the results may be disproportionate because sourcing the gain foreign may provide the taxpayer with minimal tax benefits (because the gain is assigned to the passive basket) but the loss may reduce (sometimes as a separate limitation loss) income that is otherwise sheltered by foreign tax credits. In addition, allocating loss to the passive basket raises the policy concerns described above with respect to passive-basket dividend recapture. After consideration of the comments, the consistency rule has been eliminated from the final regulations.

*Section 1.865–2(b)(2): Anti-abuse Rules*

The anti-abuse rules of §1.865–2(b)(3) of the proposed regulations, finalized as §1.865–2(b)(4), have been refined and modified. One commentator requested examples illustrating the anti-abuse rules. Examples have been provided. An additional rule is provided in §1.865–2T, discussed below.

*Section 1.865–2(e): Effective Date and Retroactive Election*

The proposed regulations are proposed to be effective for taxable years beginning 61 days after final regulations are promulgated. Because of the immediate need for guidance following the *International Multifoods* opinion, the final regulations are effective for losses recognized on or after January 11, 1999.

Several commentators requested that the regulations clarify the scope of the retroactive election and reduce the administrative burden of making the election. In response to these comments, §1.865–2(e)(2) is amended to provide that a taxpayer need not make a formal election to retroactively apply the regulations to losses recognized in any post-1986 year and all subsequent pre-effective date years. An amended return will be required only if retroactive application results in a change in tax liability.

One commentator urged that the overall foreign loss transition rule in §1.904(f)–12 be modified to provide that an overall foreign loss account attributable to a stock loss recognized in a pre-1987 year be recomputed under the new regulations in the first election year. This suggestion was rejected because the allocation of a stock loss is governed by the rules in effect in the year the loss is recognized, and the retroactive election is available only with respect to post-1986 years. Section 1.865–2(e)(3) provides examples to illustrate the effect of the retroactive application of the regulations on overall foreign loss accounts, capital loss carryovers, and foreign tax credit carryovers.

*Section 1.865–2T: Stock Loss Matching Rule*

Section 1.865–2T(b)(4)(iii) provides a rule intended to prevent taxpayers from avoiding the dividend recapture rule of §1.865–2(b)(1) or from accelerating foreign source income and recognizing an offsetting U.S. loss. This rule is substantially the same as the matching rule of §1.865–1T(c)(6)(iii). The rule is promulgated as a temporary regulation because it is necessary to prevent abuse of the residence-based general allocation rule.

*Section 1.904–4(c): Grouping Rules*

The high-tax kick-out grouping rules of §1.904–4(c) provide rules for determining when particular groups of passive income are high-taxed and, therefore, treated as general limitation income under sections 904(d)(2)(A)(iii)(III) and 904(d)(2)(F). As described above, the proposed amendments to these rules that were proposed in 1992 are finalized as proposed, but taxpayers are afforded some flexibility with respect to the effective date. The amendments were proposed to be effective for taxable years beginning after December 31, 1991. The final regulations are effective for taxable years ending on or after December 31, 1998, but taxpayers may apply the amended regulations to any taxable year beginning after December 31, 1991 and all subsequent years. An example is also added to clarify that foreign taxes that are not creditable (e.g., under section 901(k)) are not withholding taxes for purposes of the grouping rules.

The proposed amendments to the grouping rules that were proposed in 1996 are finalized with two clarifications. Proposed §1.904–4(c)(2)(ii)(B) provides guidance where deductions allocated to a group of passive income exceed the income in that group (i.e., a loss group). A question has been raised as to the proper treatment of foreign taxes in a group that has no taxable income or loss (either because the deductions allocated to the group exactly equal the income in the group or because the foreign taxes assigned to the group are imposed on U.S. source income or income that is not currently taken into account under U.S. tax principles). Consistent with the approach taken in the proposed regulations with respect to loss groups, the final regulations clarify that foreign taxes allocated to a group with no foreign source income are "kicked out" and treated as related to general limitation income.

Proposed §1.904–4(c)(2)(ii)(A) provides that foreign tax imposed on sales that result in loss for U.S. tax purposes is allocated to the group of passive income to which the loss is allocated. While this correctly states the result where loss on the disposition of property is allocated to passive income under a reciprocal-to-gain rule, under the temporary and final regulations loss may be allocated to reduce the group of passive income where income from the property was assigned (for example, dividends or interest under the anti-abuse rules or the accrued-but-unpaid interest rule) or a separate category of income other than passive income. Accordingly, §1.904–4(c)(2)(ii)(A) of the final regulations is clarified to state that foreign tax imposed on a loss sale is allocated to the group of passive income to which a gain would have been assigned. The examples in §1.904–4(c)(8) of the final regulations are modified to reflect the fact that the consistency rule of §1.865–2(b)(2) of the proposed regulations has been deleted.

One commentator inquired whether the rule of §1.904–4(c)(2)(ii)(A) allocating foreign tax on a loss sale to a group of passive income is consistent with the tax allocation rule of §1.904–6(a)(1)(iv). The latter rule provides that a foreign tax imposed on an item of income that does not constitute income under U.S. tax principles (a base difference) shall be treated as imposed with respect to general limitation income, whereas a foreign tax imposed on an item that would be income under U.S. tax principles in another year (a timing difference) will be allocated to the appropriate separate category as if the U.S. recognized the income in the same year. Treasury and the Service believe that a base difference exists within the meaning of §1.904–6(a)(1)(iv) only when a foreign country taxes items that the United States would never treat as taxable income, for example, gifts or life insurance proceeds. A sale that results in gain under foreign law but in loss for U.S. tax purposes is attributable to differences in basis calculations rather than to a difference in the concept of taxable income and, therefore, does not constitute a base difference. The tax allocation rule of §1.904–4(c)(2)(ii)(A), allocating foreign taxes on a loss sale to the same group of passive income to which gain would have been assigned had the United States recognized gain on the sale, is conceptually consistent with the treatment of timing differences in §1.904–6(a)(1)(iv).

*Effect on Other Documents*

The following document is obsolete as of January 11, 1999:

Notice 89–58, 1989–1 C.B. 699.

*Special Analyses*

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required.

This Treasury Decision finalizes notices of proposed rulemaking published May 14, 1992 (57 F.R. 20660) and July 8, 1996 (61 F.R. 35696). It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the final regulations issued pursuant to the notice of proposed rulemaking published on May 14, 1992. Furthermore, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to those regulations, because the notice of proposed rulemaking was issued prior to March 29, 1996.

It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the portion of the notice of proposed rulemaking published on July 8, 1996, relating to section 904 of the Internal Revenue Code. Because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

A final regulatory flexibility analysis under 5 U.S.C. § 604 has been prepared for the final regulations portion of this Treasury Decision with respect to the regulations issued under section 865 of the Internal Revenue Code. A summary of the analysis is set forth below under the heading 'Summary of Regulatory Flexibility Analysis.' Because no preceding notice of proposed rulemaking is required for the temporary regulations portion of this Treasury Decision relating to sections 861 and 865 of the Code, the provisions of the Regulatory Flexibility Act do not apply. However, an initial Regulatory Flexibility Analysis was prepared for the proposed regulations published elsewhere in this issue of the **Federal Register.**

Pursuant to section 7805(f) of the Internal Revenue Code, the notices of proposed rulemaking preceding these regulations were submitted to the Small

Business Administration for comment on their impact on small business.

*Summary of Regulatory Flexibility Analysis*

It has been determined that a final regulatory flexibility analysis is required under 5 U.S.C. § 604 with respect to the final regulations portion of this Treasury Decision with respect to the regulations issued under section 865 of the Internal Revenue Code. These regulations will affect small entities such as small businesses but not other small entities, such as local government or tax exempt organizations, which do not pay taxes. The IRS and Treasury Department are not aware of any federal rules that duplicate, overlap or conflict with these regulations. The final regulations address the allocation of loss with respect to stock. These regulations are necessary primarily for the proper computation of the foreign tax credit limitation under section 904 of the Internal Revenue Code. With respect to U.S. resident taxpayers, the regulations generally allocate losses against U.S. source income. Generally, this allocation simplifies the computation of the foreign tax credit limitation. None of the significant alternatives considered in drafting the regulations would have significantly altered the economic impact of the regulations on small entities. There are no alternative rules that are less burdensome to small entities but that accomplish the purposes of the statute.

*Drafting Information*

The principal author of these regulations is Seth B. Goldstein, of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

*Adoption of Amendments to the Regulations*

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.865–1T also issued under 26 U.S.C. 865(j)(1).
Section 1.865–2 also issued under 26 U.S.C. 865(j)(1).
Section 1.865–2T also issued under 26 U.S.C. 865(j)(1). * * *

Par. 2. Section 1.861–8 is amended by adding paragraph (e)(7)(iii) and revising paragraph (e)(8) to read as follows:

*§1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.*

* * * * *

(e) * * *

(7) * * *

(iii) *Allocation of loss recognized in taxable years after 1986.* See §§1.865–1T, 1.865–2, and 1.865–2T for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) *Net operating loss deduction.* [Reserved.] For guidance, see §1.861–8T(e)(8).

* * * * *

Par. 3. Section 1.861–8T is amended by adding paragraph (e)(8) and a sentence at the end of paragraph (h) to read as follows:

*§1.861–8T Computation of taxable income from sources within the United States and from other sources and activities (Temporary).*

* * * * *

(e) * * *

(8) *Net operating loss deduction*. A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

* * * * *

(h) * * * Paragraph (e)(8) of this section shall cease to be effective January 8, 2002.

Par. 4. Section 1.865–1T is added immediately following §1.864–8T, to read as follows:

*§1.865–1T Loss with respect to personal property other than stock (Temporary).*

(a) *General rules for allocation of loss*—(1) *Allocation against gain.* Except as otherwise provided in §§1.865–2 and 1.865–2T and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. Thus, for example, loss recognized by a United States resident on the sale of a bond generally is allocated to reduce United States source income.

(2) *Loss attributable to foreign office.* Except as otherwise provided in §§1.865–2 and 1.865–2T and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to property that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the property would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent. However, paragraph (a)(1) of this section and not this paragraph (a)(2) will apply if gain on the sale of such property would be sourced under section 865(c), (d)(1)(B), or (d)(3).

(3) *Loss recognized by United States citizen or resident alien with foreign tax home.* Except as otherwise provided in §§1.865–2 and 1.865–2T and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss with respect to property recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of such property would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(4) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to property that is

allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on the sale of the property would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of §1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of §1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the property would have been assigned had a sale of the property resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(5) *Loss recognized by partnership.* A partner's distributive share of loss recognized by a partnership with respect to personal property shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(b) *Special rules of application*—(1) *Depreciable property.* In the case of a loss recognized with respect to depreciable personal property, the gain referred to in paragraph (a)(1) of this section is the gain that would be sourced under section 865(c)(1) (depreciation recapture).

(2) *Contingent payment debt instrument.* Except to the extent provided in §1.1275–4(b)(9)(iv), loss recognized with respect to a contingent payment debt instrument to which §1.1275–4(b) applies (instruments issued for money or publicly traded property) shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the instrument (in the amount of the loss subject to this paragraph (b)(2)) would give rise.

(c) *Exceptions*—(1) *Foreign currency and certain financial instruments.* This section does not apply to loss governed by section 988 and loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

(2) *Inventory.* This section does not apply to loss recognized with respect to property described in section 1221(1).

(3) *Interest equivalents and trade receivables.* Loss subject to §1.861–9T(b) (loss equivalent to interest expense and loss on trade receivables) shall be allocated and apportioned under the rules of §1.861–9T and not under the rules of this section.

(4) *Unamortized bond premium.* To the extent a taxpayer recognizing loss with respect to a bond (within the meaning of §1.171–1(b)) did not amortize bond premium to the full extent permitted by §§1.171–2 or 1.171–3 (or §1.171–1, as contained in the 26 CFR part 1 edition revised as of April 1, 1997)(as applicable), loss recognized with respect to the bond shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the bond was assigned.

(5) *Accrued interest.* Loss attributable to accrued but unpaid interest on a debt obligation shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the obligation was assigned. For purposes of this section, whether loss is attributable to accrued but unpaid interest (rather than to principal) shall be determined under the principles of §§1.61–7(d) and 1.446–2(e).

(6) *Anti-abuse rules*—(i) *Transactions involving built-in losses.* If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to personal property by transferring the property to another person, qualified business unit, office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to personal property, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss on the disposition of personal property by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, transfers to or from a qualified business unit, office or other fixed place of business, or branch, or exchanges under section 1031. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions.* If a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income. For purposes of this paragraph (c)(6)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule.* To the extent a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to personal property, the loss shall be allocated and apportioned against such income. For examples illustrating a similar rule with respect to stock loss, see Examples 3 through 6 of §1.865–2T(b)(4)(iv).

(d) *Definitions*—(1) *Contingent payment debt instrument.* A contingent payment debt instrument is any debt instrument that is subject to §1.1275–4.

(2) *Depreciable personal property.* Depreciable personal property is any property described in section 865(c)(4)(A).

(3) *Terms defined in §1.861–8.* See §1.861–8 for the meaning of class of gross income, statutory grouping of gross income, and residual grouping of gross income.

(e) *Examples.* The application of this section may be illustrated by the following examples:

*Example 1.* On January 1, 1997, *A*, a domestic corporation, purchases for $1,000 a machine that produces widgets, which *A* sells in the United States and throughout the world. Throughout *A*'s holding period, the machine is located and used in Country *X*. During *A*'s holding period, *A* incurs depreciation deductions of $400 with respect to the machine. Under §1.861–8, *A* allocates and apportions depreciation deductions of $250 against foreign source general limitation income and $150 against U.S. source income. On December 12, 1999, *A* sells the machine and recognizes a loss of $500. Because the machine was used predominantly outside the United States, under section 865(c)(1)(B) and (c)(3)(B)(ii), gain on the disposition of the machine would be foreign source general limitation income to the extent of the depreciation adjustments. Therefore, under paragraph (b)(1) of this section, the entire $500 loss is allocated against foreign source general limitation income.

*Example 2.* On January 1, 1997, *A*, a domestic corporation, loans $2,000 to *N*, its wholly-owned controlled foreign corporation, in exchange for a contingent payment debt instrument subject to §1.1275–4(b). During 1997 through 1999, *A* accrues and receives interest income of $630, $150 of which is foreign source general limitation income and $480 of which is foreign source passive income under section 904(d)(3). Assume there are no positive or negative adjustments pursuant to §1.1275–4(b)(6) in 1997 through 1999. On January 1, 2000, A disposes of the debt instrument and recognizes a $770 loss. Under §1.1275–4(b)(8)(ii), $630 of the loss is treated as ordinary loss and $140 is treated as capital loss. Assume that $140 of interest income earned in 2000 with respect to the debt instrument would be foreign source passive income under section 904(d)(3). Under §1.1275–4(b)(9)(iv), $150 of the ordinary loss is allocated against foreign source general limitation income and $480 of the ordinary loss is allocated against foreign source passive income. Under paragraph (b)(2) of this section, the $140 capital loss is allocated against foreign source passive income.

*Example 3.* On January 1, 1997, *A*, a domestic corporation, purchases for $1,000 a bond maturing January 1, 2009, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Between 1997 and 2001, *A* accrues and receives foreign source interest income of $500 with respect to the bond. On January 1, 2002, *A* sells the bond and recognizes a $500 loss. Under paragraph (a)(1) of this section, the $500 loss is allocated against U.S. source income. Paragraph (c)(6)(iii) of this section is not applicable because A's recognition of the foreign source income did not result in the creation of a corresponding loss with respect to the bond.

*Example 4.* On January 1, 1999, *A*, a domestic corporation on the accrual method of accounting, purchases for $1,000 a bond maturing January 1, 2009, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. On June 10, 1999, after *A* has accrued $44 of interest income, but before any interest has been paid, the issuer suddenly becomes insolvent and declares bankruptcy. *A* sells the bond (including the accrued interest) for $20. Assuming that *A* properly accrued $44 interest income, *A* treats the $20 proceeds from the sale of the bond as payment of interest previously accrued and recognizes a $1000 loss with respect to the bond principal and a $24 loss with respect to the accrued interest. See §1.61–7(d). Under paragraph (a)(1) of this section, the $1000 loss with respect to the principal is allocated against U.S. source income. Under paragraph (c)(5) of this section, the $24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) *Effective date*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, this section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (f), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account. This section shall cease to be effective January 8, 2002.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples.* See §1.865–2(e)(3) for examples illustrating an effective date provision similar to the effective date provided in this paragraph (f).

Par. 5. Section 1.865–2 is added immediately after §1.865–1T, to read as follows:

*§1.865–2 Loss with respect to stock.*

(a) *General rules for allocation of loss with respect to stock*—(1) *Allocation against gain.* Except as otherwise provided in paragraph (b) of this section, loss recognized with respect to stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 964(e)(1) or 1248) from a sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). Thus, for example, loss recognized by a United States resident on the sale of stock generally is allocated to reduce United States source income.

(2) *Stock attributable to foreign office.* Except as otherwise provided in paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to stock that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(3) *Loss recognized by United States citizen or resident alien with foreign tax home*—(i) *In general.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock that is recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of the stock would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(ii) *Bona fide residents of Puerto Rico.* Except as otherwise provided in paragraph (b) of this section, in the case of loss with respect to stock in a corporation described in section 865(g)(3) recognized by a United States citizen or resident alien that is a bona fide resident of Puerto Rico during the entire taxable year, the loss shall be allocated to reduce foreign source income.

(4) *Stock constituting a United States real property interest.* Loss recognized

by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States real property interest shall be allocated to reduce United States source income. For additional rules governing the treatment of such loss, see section 897 and the regulations thereunder.

(5) *Allocation for purposes of section 904.* For purposes of section 904, loss recognized with respect to stock that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on a sale of the stock would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of §1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of §1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the stock would have been assigned had a sale of the stock resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(b) *Exceptions*—(1) *Dividend recapture exception*—(i) *In general.* If a taxpayer recognizes a loss with respect to shares of stock, and the taxpayer (or a person described in section 1059(c)(3)(C) with respect to such shares) included in income a dividend recapture amount (or amounts) with respect to such shares at any time during the recapture period, then, to the extent of the dividend recapture amount (or amounts), the loss shall be allocated and apportioned on a proportionate basis to the class or classes of gross income or the statutory or residual grouping or groupings of gross income to which the dividend recapture amount was assigned.

(ii) *Exception for de minimis amounts.* Paragraph (b)(1)(i) of this section shall not apply to a loss recognized by a taxpayer on the disposition of stock if the sum of all dividend recapture amounts (other than dividend recapture amounts eligible for the exception described in paragraph (b)(1)(iii) of this section (passive limitation dividends)) included in income by the taxpayer (or a person described in section 1059(c)(3)(C)) with respect to such stock during the recapture period is less than 10 percent of the recognized loss.

(iii) *Exception for passive limitation dividends.* Paragraph (b)(1)(i) of this section shall not apply to the extent of a dividend recapture amount that is treated as income in the separate category for passive income described in section 904(d)(2)(A) (without regard to section 904(d)(2)(A)(iii)(III)). The exception provided for in this paragraph (b)(1)(iii) shall not apply to any dividend recapture amount that is treated as income in the separate category for financial services income described in section 904(d)(2)(C).

(iv) *Examples.* The application of this paragraph (b)(1) may be illustrated by the following examples:

*Example 1.* (i) *P*, a domestic corporation, is a United States shareholder of *N*, a controlled foreign corporation. *N* has never had any subpart *F* income and all of its earnings and profits are described in section 959(c)(3). On May 5, 1998, *N* distributes a dividend to *P* in the amount of $100. The dividend gives rise to a $5 foreign withholding tax, and *P* is deemed to have paid an additional $45 of foreign income tax with respect to the dividend under section 902. Under the look-through rules of section 904(d)(3) the dividend is general limitation income described in section 904(d)(1)(I).

(ii) On February 6, 2000, *P* sells its shares of *N* and recognizes a $110 loss. In 2000, *P* has the following taxable income, excluding the loss on the sale of *N*:

(A) $1,000 of foreign source income that is general limitation income described in section 904(d)(1)(I);

(B) $1,000 of foreign source capital gain from the sale of stock in a foreign affiliate that is sourced under section 865(f) and is passive income described in section 904(d)(1)(A); and

(C) $1,000 of U.S. source income.

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N* stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation income).

(iv) *P*'s remaining $10 loss on the disposition of the N stock is allocated to U.S. source income under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, P's foreign source taxable income in 2000 consists of $900 of foreign source general limitation income and $1,000 of foreign source passive income.

*Example 2.* (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*, which owns all of the stock of *N3*. *N1, N2*, and *N3* are controlled foreign corporations. All of the corporations use the calendar year as their taxable year. On February 5, 1997, *N3* distributes a dividend to *N2*. The dividend is foreign personal holding company income of *N2* under section 954(c)(1)(A) that results in an inclusion of $100 in *P*'s income under section 951(a)(1)(A)(i) as of December 31, 1997. Under section 904(d)(3)(B) the inclusion is general limitation income described in section 904(d)(1)(I). The income inclusion to *P* results in a corresponding increase in *P*'s basis in the stock of *N1* under section 961(a).

(ii) On March 5, 1999, *P* sells its shares of *N1* and recognizes a $110 loss. The $100 1997 subpart *F* inclusion is a dividend recapture amount that was included in *P*'s income within the recapture period preceding the disposition of the *N1* stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend recapture amount was assigned (general limitation income). The remaining $10 loss is allocated to U.S. source income under paragraph (a)(1) of this section.

*Example 3.* (i) *P*, a domestic corporation, owns all of the stock of *N1*, which owns all of the stock of *N2*. *N1* and *N2* are controlled foreign corporations. All the corporations use the calendar year as their taxable year and the U.S. dollar as their functional currency. On May 5, 1998, *N2* pays a dividend of $100 to *N1* out of general limitation earnings and profits.

(ii) On February 5, 2000, *N1* sells its *N2* stock to an unrelated purchaser. The sale results in a loss to *N1* of $110 for U.S. tax purposes. In 2000, *N1* has the following current earnings and profits, excluding the loss on the sale of *N2:*

(A) $1,000 of non-subpart *F* foreign source general limitation earnings and profits described in section 904(d)(1)(I);

(B) $1,000 of foreign source gain from the sale of stock that is taken into account in determining foreign personal holding company income under section 954(c)(1)(B)(i) and which is passive limitation earnings and profits described in section 904(d)(1)(A);

(C) $1,000 of foreign source interest income received from an unrelated person that is foreign personal holding company income under section 954(c)(1)(A) and which is passive limitation earnings and profits described in section 904(d)(1)(A).

(iii) The $100 dividend paid in 1998 is a dividend recapture amount that was included in *N1*'s income within the recapture period preceding the disposition of the *N2* stock. The de minimis exception of paragraph (b)(1)(ii) of this section does not apply because the $100 dividend recapture amount exceeds 10 percent of the $110 loss. Therefore, to the extent of the $100 dividend recapture amount, the loss must be allocated under paragraph (b)(1)(i) of this section to the separate limitation category to which the dividend was assigned (general limitation earnings and profits).

(iv) *N1*'s remaining $10 loss on the disposition of the *N2* stock is allocated to foreign source passive limitation earnings and profits under paragraph (a)(1) of this section.

(v) After allocation of the stock loss, *N1*'s current earnings and profits for 1998 consist of $900 of foreign source general limitation earnings and profits and $1,990 of foreign source passive limitation earnings and profits.

(vi) After allocation of the stock loss, *N1*'s subpart F income for 2000 consists of $1,000 of foreign source interest income that is foreign personal holding company income under section 954(c)(1)(A) and $890 of foreign source net gain that is foreign personal holding company income under section 954(c)(1)(B)(i). P includes $1,890 in income under section 951(a)(1)(A)(i) as passive income under sections 904(d)(1)(A) and 904(d)(3)(B).

*Example 4.* *P*, a foreign corporation, has two wholly-owned subsidiaries, *S*, a domestic corporation, and *B*, a foreign corporation. On January 1, 2000, S purchases a one-percent interest in *N*, a foreign corporation, for $100. On January 2, 2000, *N* distributes a $20 dividend to *S*. The $20 dividend is foreign source financial services income. On January 3, 2000, S sells its *N* stock to *B* for $80 and recognizes a $20 loss that is deferred under section 267(f). On June 10, 2008, *B* sells its *N* stock to an unrelated person for $55. Under section 267(f) and §1.267(f)–1(c)(1), *S*'s $20 loss is deferred until 2008. Under this paragraph (b)(1), the $20 loss is allocated to reduce foreign source financial services income in 2008 because the loss was recognized (albeit deferred) within the 24-month recapture period following the receipt of the dividend. See §§1.267(f)–1(a)(2)(i)(B) and 1.267(f)–1(c)(2).

*Example 5.* The facts are the same as in *Example 4,* except *P, S,* and *B* are domestic corporations and members of the *P* consolidated group. Under the matching rule of §1.1502–13(c)(1), the separate entity attributes of *S*'s intercompany items and *B*'s corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if *S* and *B* were divisions of a single corporation and the intercompany transaction was a transaction between divisions. If *S* and *B* were divisions of a single corporation, the transfer of *N* stock on January 3, 2000 would be ignored for tax purposes, and the corporation would be treated as selling that stock only in 2008. Thus, the corporation's entire $45 loss would have been allocated against U.S. source income under paragraph (a)(1) of this section because a dividend recapture amount was not received during the corporation's recapture period. Accordingly, *S*'s $20 loss and *B*'s $25 loss are allocated to reduce U.S. source income.

(2) *Exception for inventory.* This section does not apply to loss recognized with respect to stock described in section 1221(1).

(3) *Exception for stock in an S corporation.* This section does not apply to loss recognized with respect to stock in an S corporation (as defined in section 1361).

(4) *Anti-abuse rules*—(i) *Transactions involving built-in losses*. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock by transferring the stock to another person, qualified business unit (within the meaning of section 989(a)), office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized with respect to the stock by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to stock, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to stock (or other personal property) by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, or transfers to or from a qualified business unit, office or other fixed place of business. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions.* If a taxpayer recognizes loss with respect to stock and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such stock with a principal purpose of recognizing foreign source income and United States source loss, the loss will be allocated and apportioned against such foreign source income. For purposes of this paragraph (b)(4)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule.* [Reserved] For further guidance, see §1.865–2T(b)(4)(iii).

(iv) *Examples.* The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

*Example 1.* (i) *Facts.* On January 1, 2000, *P*, a domestic corporation, owns all of the stock of *N1*, a controlled foreign corporation, which owns all of the stock of *N2*, a controlled foreign corporation. *N1*'s basis in the stock of *N2* exceeds its fair market value, and any loss recognized by *N1* on the sale of *N2* would be allocated under paragraph (a)(1) of this section to reduce foreign source passive limitation earnings and profits of *N1*. In contemplation of the sale of *N2* to an unrelated purchaser, *P* causes *N1* to liquidate with principal purposes of recognizing the loss on the *N2* stock and allocating the loss against U.S. source income. *P* sells the *N2* stock and P recognizes a loss.

(ii) *Loss allocation.* Because one of the principal purposes of the liquidation was to transfer the stock to *P* in order to change the allocation of the built-in loss on the *N2* stock, under paragraph (b)(4)(i) of this section the loss is allocated against *P*'s foreign source passive limitation income.

*Example 2.* (i) *Facts.* On January 1, 2000, *P*, a domestic corporation, forms *N* and *F*, foreign corporations, and contributes $1,000 to the capital of each. *N* and *F* enter into offsetting positions in financial instruments that produce financial services income. Holding the *N* stock substantially diminishes *P*'s risk of loss with respect to the F stock (and vice versa). *P* holds *N* and *F* with a principal purpose of recognizing foreign source income and U.S. source loss. On March 31, 2000, when the financial instrument held by *N* is worth $1,200 and the financial instrument held by *F* is worth $800, *P* sells its *F* stock and recognizes a $200 loss.

(ii) *Loss allocation*. Because *P* held an offsetting position with respect to the *F* stock with a principal purpose of recognizing foreign source income and U.S. source loss, the $200 loss is allocated against foreign source financial services income under paragraph (b)(4)(ii) of this section.

(c) *Loss recognized by partnership.* A partner's distributive share of loss recognized by a partnership shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(d) *Definitions*—(1) *Terms defined in §1.861–8.* See §1.861–8 for the meaning of *class of gross income, statutory grouping of gross income,* and *residual grouping of gross income.*

(2) *Dividend recapture amount.* A dividend recapture amount is a dividend (except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the

extent attributable to a dividend (including a dividend under section 964(e)(1)) included in the earnings of a controlled foreign corporation (held directly or indirectly by the person recognizing the loss) that is included in foreign personal holding company income under section 954(c)(1)(A)) and an inclusion described in section 951(a)(1)(B).

(3) *Recapture period.* A recapture period is the 24-month period preceding the date on which a taxpayer recognizes a loss with respect to stock, increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against risk of loss with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired.

(4) *United States resident.* See section 865(g) and the regulations thereunder for the definition of United States resident.

(e) *Effective date*—(1) *In general.* This section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section and §1.865–2T for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples.* The rules of this paragraph (e) may be illustrated by the following examples:

*Example 1.* (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1985, P recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1985 and is carried over to the 1990 taxable year. The loss is allocated against foreign source income under §1.861–8(e)(7). In 1999, P chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years.

(ii) Allocation of the loss on the sale of *N* is not affected by the rules of this section because the loss was recognized in a taxable year that did not begin after December 31, 1986.

*Example 2.* (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1988, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. Pursuant to sections 1211(a) and 1212(a), the loss is not allowed in 1988 and is carried back to the 1985 taxable year. The loss is allocated against foreign source income under §1.861–8(e)(7) on *P*'s federal income tax return for 1985 and increases an overall foreign loss account under §1.904(f)–1.

(ii) In 1999, *P* chooses to apply this section to all losses recognized in its 1987 taxable year and in all subsequent years. Consequently, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income reduces *P*'s overall foreign loss account and increases *P*'s tax liability in 2 years: 1990, a year that will not be open for assessment on June 30, 1999, and 1997, a year that will be open for assessment on June 30, 1999. Pursuant to paragraph (e)(2)(i) of this section, *P* must file an amended federal income tax return that reflects the rules of this section for 1997, but not for 1990.

*Example 3.* (i) *P*, a domestic corporation, has a calendar taxable year. On March 10, 1989, *P* recognizes a $100 capital loss on the sale of *N*, a foreign corporation. The loss is allocated against foreign source income under §1.861–8(e)(7) on *P*'s federal income tax return for 1989 and results in excess foreign tax credits for that year. The excess credit is carried back to 1988, pursuant to section 904(c). In 1999, *P* chooses to apply this section to all losses recognized in its 1989 taxable year and in all subsequent years. On June 30, 1999, *P*'s 1988 taxable year is closed for assessment, but *P*'s 1989 taxable year is open with respect to claims for refund.

(ii) Because *P* chooses to apply this section to its 1989 taxable year, the loss on the sale of *N* is allocated against U.S. source income under paragraph (a)(1) of this section. Allocation of the loss against U.S. source income would have permitted the foreign tax credit to be used in 1989, reducing *P*'s tax liability in 1989. Nevertheless, under paragraph (e)(2)(ii) of this section, because the credit was carried back to 1988, *P* may not claim the foreign tax credit in 1989.

Par. 6. Section 1.865–2T is added immediately after §1.865–2, to read as follows:

*§1.865–2T Loss with respect to stock (Temporary).*

(a) through (b)(4)(ii) [Reserved] For further guidance, see §1.865–2(a) through (b)(4)(ii).

(b)(4)(iii) *Matching rule.* To the extent a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to stock, the loss shall be allocated and apportioned against such income. This paragraph (b)(4)(iii) shall not apply to the extent a loss is related to a dividend recapture amount and §1.865–2(b)(1)(ii) (de minimis exception) or (b)(1)(iii) (passive dividend exception) exempts the loss from §1.865–2(b)(1)(i) (dividend recapture rule), unless the stock is held with a principal purpose of producing foreign source income and corresponding loss.

(iv) *Examples.* The application of this paragraph (b)(4) may be illustrated by the following examples. No inference is intended regarding the application of any other Internal Revenue Code section or judicial doctrine that may apply to disallow or defer the recognition of loss. The examples are as follows:

*Examples 1 and 2.* [Reserved] For further guidance, see §1.865–2(b)(4)(iv).

*Example 3.* (i) *Facts.* On January 1, 1999, *P* and *Q*, domestic corporations, form *R*, a domestic partnership. The corporations and partnership use the calendar year as their taxable year. *P* contributes $900 to *R* in exchange for a 90- percent partnership interest and *Q* contributes $100 to *R* in exchange for a 10-percent partnership interest. *R* purchases a dance studio in country *X* for $1,000. On January 2, 1999, *R* enters into contracts to provide dance lessons in Country *X* for a 5-year period beginning January 1, 2000. These contracts are prepaid by the dance studio customers on December 31, 1999, and *R* recognizes foreign source taxable income of $500 from the prepayments (*R*'s only income in 1999). *P* takes into income its $450 distributive share of partnership taxable income. On January 1, 2000, *P*'s basis in its partnership interest is $1,350 ($900 from its contribution under section 722, increased by its $450 distributive share of partnership income under section 705). On September 22, 2000, *P* contributes its *R* partnership interest to *S*, a newly-formed domestic corporation, in exchange for all the stock of *S*. Under section 358, *P*'s basis in *S* is $1,350. On December 1, 2000, *P* sells *S* to an unrelated party for $1050 and recognizes a $300 loss.

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *S* stock, the $300 loss is allocated against foreign source income under paragraph (b)(4)(iii) of this section.

*Example 4.* (i) *Facts.* On January 1, 2000, *P*, a domestic corporation that uses the calendar year as its taxable year forms *N*, a foreign corporation. *P* contributes $1,000 to the capital of *N* in exchange for 100 shares of common stock. *P* contributes an additional $1,000 to the capital of *N* in exchange for 100 shares of preferred stock. Each preferred share is entitled to 15- percent dividend but is redeemable by *N* on or after January 1, 2010, for $1. Prior to

January 10, 2005, P receives a total of $750 of distributions from *N* with respect to its preferred shares, which *P* treats as foreign source general limitation dividends. On January 10, 2005, *P* sells its 100 preferred shares in *N* to an unrelated purchaser for $600. Assume that this arrangement is not recharacterized under Notice 97–21 (1997–1 C.B. 407).

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *N* stock, the $400 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

*Example 5.* (i) Facts. On January 1, 2000, *P*, a domestic corporation that uses the calendar year as its taxable year, and *F*, a newly-formed controlled foreign corporation wholly-owned by *P*, form *N*, a foreign corporation. *P* contributes $1,000 to the capital of *N* in exchange for 100 shares of common stock and $1,000 to the capital of *F* in exchange for 100 shares of common stock. *F* contributes LC1,000 to the capital of *N* in exchange for 100 shares of preferred stock. Each preferred share is entitled to a 65-percent LC dividend. At the time of the contributions, $1=LC1. The LC is expected to depreciate significantly in relation to the U.S. dollar. Prior to June 10, 2005, P receives a total of $1,900 of distributions from *F*, which it treats as foreign source general limitation dividends. On June 10, 2005, the *N* preferred stock has a fair market value of $25 and *P* sells *F* for $25 to an unrelated person. Assume that this arrangement is not recharacterized under Notice 97–21 (1997–1 C.B. 407).

(ii) *Loss allocation.* Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *F* stock, the $975 loss is allocated against foreign source general limitation income under paragraph (b)(4)(iii) of this section.

*Example 6.* (i) Facts. On January 1, 1998, *P*, a domestic corporation, purchases *N*, a foreign corporation, for $1000. On March 1, 1998, *N* sells its operating assets, distributes a $400 general limitation dividend to *P*, and invests its remaining $600 in short term government securities. *N* earns interest income from the securities. The income constitutes subpart *F* income that is included in *P*'s income under section 951, increasing *P*'s basis in the *N* stock under section 961(a). On March 1, 2002, *P* sells *N* and recognizes a $400 loss.

(ii) *Loss allocation.* The $400 dividend received by *P* resulted in a $400 built-in loss in the *N* stock, which was locked in for *P*'s four-year holding period. Because *P* recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the *N* stock, under paragraph (b)(4)(iii) of this section the $400 loss is allocated against foreign source general limitation income.

(e) *Effective date*—(1) *In general*. This section is effective for loss recognized on or after January 11, 1999. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account. This section shall cease to be effective January 8, 2002.

(2) *Application to prior periods.* A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section and §1.865–2 for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(ii) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

Par. 7. Section 1.904–0 is amended by revising the entry for §1.904–4(c)(2)(i) and (ii) and adding entries for paragraphs (c)(2)(i)(A), (c)(2)(i)(B), (c)(2)(ii)(A) and (c)(2)(ii)(B) to read as follows:

*§1.904–0 Outline of regulation provisions for section 904.*

* * * * *

*§1.904–4 Separate application of section 904 with respect to certain categories of income.*

* * * * *

(c) * * *
(2) * * *
(i) Effective dates.
(A) In general.
(B) Application to prior periods.
(ii) Grouping rules.
(A) Initial allocation and apportionment of deductions and taxes.
(B) Reallocation of loss groups.

* * * * *

Par. 8. Section 1.904–4 is amended by:

1. Revising paragraphs (c)(1) and (c)(2),
2. Revising paragraph (c)(3)(iii),
3. Adding paragraph (c)(3)(iv), and
4. Amending paragraph (c)(8) by adding *Example 11, Example 12* and *Example 13.*
5. The additions and revisions read as follows:

*§1.904–4 Separate application of section 904 with respect to certain categories of income.*

* * * * *

(c) *High-taxed income*—(1) *In general.* Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general limitation income, and any taxes imposed on that income shall be considered related to general limitation income under §1.904–6. If, after application of this paragraph (c), passive income is zero or less than zero, any taxes imposed on the passive income shall be considered related to general limitation income. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) *Examples* 10 through 13 of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*—(i) *Effective dates*—(A) *In general.* For purposes of determining whether passive income is

high-taxed income, the grouping rules of paragraphs (c)(3)(i) and (ii), (c)(4), and (c)(5) of this section apply to taxable years beginning after December 31, 1987. Except as provided in paragraph (c)(2)(i)(B) of this section, the rules of paragraph (c)(3)(iii) apply to taxable years beginning after December 31, 1987, and ending before December 31, 1998, and the rules of paragraph (c)(3)(iv) apply to taxable years ending on or after December 31, 1998. See Notice 87–6 (1987-1 C.B.417) for the grouping rules applicable to taxable years beginning after December 31, 1986 and before January 1, 1988. The fourth sentence of paragraph (c)(2)(ii)(A) and paragraph (c)(2)(ii)(B) of this section are effective for taxable years beginning after March 12, 1999.

(B) *Application to prior periods.* A taxpayer may apply the rules of paragraph (c)(3)(iv) to any taxable year beginning after December 31, 1991, and all subsequent years, provided that—

(*1*) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 1999; and

(*2*) The taxpayer makes appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(ii) *Grouping rules*—(A) *Initial allocation and apportionment of deductions and taxes.* For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in paragraphs (c)(3), (4), and (5) of this section) under the rules of §§1.861–8 through 1.861–14T and 1.865–1T through 1.865–2T. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. Foreign taxes are allocated to groups under the rules of §1.904–6(a)(iii). If a loss on a disposition of property gives rise to foreign tax (i.e., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which gain on the sale would have been assigned under paragraph (c)(3) or (4) of this section. A determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii)(B) of this section (if applicable).

(B) *Reallocation of loss groups.* If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(ii)(A) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero).

(3) * * *

(iii) For taxable years ending before December 31, 1998 (except as provided in paragraph (c)(2)(i)(B) of this section), all passive income received during the taxable year that is subject to no withholding tax shall be treated as one item of income.

(iv) For taxable years ending on or after December 31, 1998, all passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income, and all passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

* * * * *

(8) * * *

*Example 11.* In 2001, *P*, a U.S. citizen with a tax home in Country *X*, earns the following items of gross income: $400 of foreign source, passive limitation interest income not subject to foreign withholding tax but subject to Country *X* income tax of $100, $200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is $10), $1,300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is $325), $500 of foreign source, general limitation income that gives rise to a $250 foreign tax, and $2,000 of U.S. source capital gain that is not subject to any foreign tax. *P* has a $900 deduction allocable to its passive rental income. *P*'s only other deduction is a $700 capital loss on the sale of stock that is allocated to foreign source passive limitation income under §1.865–2(a)(3)(i). The $700 capital loss is initially allocated to the group of passive income subject to no withholding tax but subject to foreign tax other than withholding tax. The $300 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of this section. The royalty income is thus reduced by $100 to $100 ($200 – ($300 × (200/600))) and the rental income is thus reduced by $200 to $200 ($400 – ($300 × (400/600))). The $100 royalty income is not high-taxed and remains passive income because the foreign taxes do not exceed the highest United States rate of tax on that income. Under the high-tax kick-out, the $200 of rental income and the $325 of associated foreign tax are assigned to the general limitation category.

*Example 12.* The facts are the same as in *Example 11* except the amount of the capital loss that is allocated under §1.865–2(a)(3)(i) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no withholding tax but subject to foreign tax other than withholding tax is $1,200. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of $800 must be reapportioned to the $200 of net royalty income subject to a 5 percent withholding tax and the $400 of net rental income subject to a 15 percent or greater withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general limitation income. The remaining loss of $200 constitutes a separate limitation loss with respect to passive income.

*Example 13.* In 2001, *P*, a domestic corporation, earns a $100 dividend that is foreign source passive limitation income subject to a 30-percent withholding tax. A foreign tax credit for the withholding tax on the dividend is disallowed under section 901(k). *A* deduction for the tax is allowed, however, under sections 164 and 901(k)(7). In determining whether *P*'s passive income is high-taxed, the $100 dividend and the $30 deduction are allocated to the first group of income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax or other foreign tax).

* * * * *

Robert E. Wenzel,
*Deputy Commissioner of Internal Revenue.*

Approved December 15, 1998.

Donald C. Lubick,
*Assistant Secretary of the Treasury.*

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# Proposed Changes to Final Withholding Regulations Under Section 1441; Proposed Model Qualified Intermediary Withholding Agreement

## NOTICE 99–8

### Background and Scope

On October 14, 1997, the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS") issued final Income Tax Regulations (the "final withholding regulations") under chapter 3 (sections 1441-1464) and subpart G of subchapter A of chapter 61 (sections 6041-6050S) of the Internal Revenue Code (the "Code"). Those regulations were published in the Federal Register as T.D. 8734 and, as modified by T.D. 8804, will generally be effective for payments made after December 31, 1999.

Section I of this notice announces some of the changes that Treasury and the IRS will make to those regulations. The changes covered by this notice are those that affect a withholding agent or payor's information systems and the type of beneficial owner or payee documentation that a withholding agent or payor must obtain before January 1, 2000.

Section II of this notice provides a proposed model qualified intermediary (QI) withholding agreement. In Rev. Proc. 98–27, 1998–15 I.R.B. 15, the IRS provided guidance on the provisions to be contained in a QI withholding agreement. In Notice 98–16, 1998–15 I.R.B. 12, issued simultaneously with Rev. Proc. 98–27, the IRS announced that it intended to issue a series of model agreements of broad applicability to make qualified intermediary agreements as widely available as possible. Under these model agreements, a person would be able to accept, sign, and submit the agreement to the IRS without the need for individual negotiations. Notice 98–16 stated that the IRS contemplated that each model agreement would be specific to a particular country or group of countries with similar laws and practices. The IRS invited submissions of proposed model agreements by groups or associations of potential qualified intermediaries.

The IRS has developed a proposed model QI withholding agreement that appears in Section II of this notice. This model will be adapted to reflect the "know-your-customer" rules applicable to each country. Other specific adaptations may be made if the IRS concludes that they are necessary to implement QI withholding agreements in that country, will not result in a competitive advantage for qualified intermediaries in that country, and do not violate principles that are fundamental to sound tax administration. Once the IRS is satisfied that a particular country's know-your-customer rules can be relied upon, or adapted, to provide reliable information, a final model QI withholding agreement will be issued for that country.

The IRS invites comments on the proposed regulation changes and the model QI withholding agreement set forth in Sections I and II of this notice. Written comments (8 copies) must be received by March 16, 1999. Send submissions to CC:DOM:CORP:R (OGI–118203–98), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20004. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (OGI–118203–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

### Section I. Proposed Changes to the Final Withholding Regulations

A. *Withholding and Information Reporting When There Is Unreliable Allocation Information.*

Under §1.1441–1(e)(3)(iii), a nonqualified intermediary is required to provide a withholding agent with a withholding certificate (Form W-8IMY) to which it attaches the withholding certificates (Forms W-8) and other appropriate documentation of the beneficial owners and payees for whom it acts. The nonqualified intermediary must also provide a statement that the account holder documentation attached to the Form W-8IMY represents all of the persons to whom the Form W-8IMY relates. If the nonqualified intermediary has not attached documentation for all of the persons to whom the Form W-8IMY relates, the nonqualified intermediary must separately identify the amounts allocable to persons for whom a withholding certificate or other appropriate documentation are lacking or unreliable. Further, under §1.1441–1(e)(3)(iv), a nonqualified intermediary must provide information sufficient for a withholding agent to determine the proportion of each payment of reportable amounts, as defined in §1.1441–1(e)(3)(iv), that is allocable to each person to whom the Form W-8IMY relates, including persons for whom the intermediary has not attached a withholding certificate or other appropriate documentation. The information for persons for whom documentation is lacking or unreliable may be provided in the aggregate and need not be provided separately for each such person. Section 1.1441–5(c)(3)(iii) provides similar rules for foreign partnerships. The allocation information required by §§1.1441–1(e)-(3)(iv) and 1.1441–5(c)(3)(iii) is necessary so that the withholding agent may file Forms 1042-S for each beneficial owner. See §1.1461–1(c)(1).

Sections 1.1441–1(b)(3)(v)(C) and 1.1441–5(d)(3)(ii) contain reporting and withholding rules that apply if a withholding agent receives from a nonqualified intermediary or a foreign partnership the Forms W-8 or other appropriate documentation from all the beneficial owners or payees in a group of beneficial owners or payees, but the withholding agent does not have information that permits it to allocate a payment of an amount subject to chapter 3 withholding to each beneficial owner or payee. In that case, the payment is presumed to be allocable entirely to the beneficial owner or payee in the group with the highest withholding rate or, if the rates are equal, to the beneficial owner or payee in the group with the highest U.S. tax liability.

Section 1.6049–5(d)(3)(ii) contains similar rules that apply for purposes of Form 1099 reporting of amounts that are not subject to chapter 3 withholding (other than short-term OID and deposit interest). These amounts include foreign source income and broker proceeds.

Under §1.6049–5(d)(3)(ii), if a payor pays an amount to a foreign intermediary and has actual knowledge that the foreign intermediary is acting on behalf of a U.S. nonexempt recipient but the payor cannot determine the portion of the payment that is allocable to the U.S. nonexempt recipient, the payor must treat the entire unallocated portion of a payment as allocable to the U.S. nonexempt recipient.

The rules of §§1.1441–1(b)(3)(v)(C), 1.1441–5(d)(3)(ii), and 1.6049–5(d)(3)(ii) permit the account holders of a nonqualified intermediary or partners of a foreign partnership to obtain a reduced rate of withholding under sections 1441 or 1442 (or to avoid imposition of backup withholding) even though the nonqualified intermediary or foreign partnership has not provided a withholding agent with information that allocates the payment to each account holder or partner. For example, a nonqualified intermediary could provide Forms W-8 for all of its beneficial owner account holders and obtain the portfolio interest exemption for those account holders without providing the withholding agent with any allocation information. Similarly, if a nonqualified intermediary provides a payor with a Form W-9 from a U.S. nonexempt payee, the unallocated portion of a payment of an amount not subject to chapter 3 withholding will be reported as if it were made to that U.S. nonexempt recipient, although no backup withholding will be imposed since the U.S. payee has provided a Form W-9.

The Treasury and the IRS have determined that the ability to obtain a reduced rate of withholding, or to avoid imposition of backup withholding, in the absence of information that allocates the payment to each beneficial owner or payee of a nonqualified intermediary or partner of a foreign partnership undermines the general rules of §§1.1441–1(e)(3)(iii) and (iv), 1.1441–5(c)(3)(iii) and (iv), chapter 61, and section 3406, which require allocation information. Further, allocation information is essential for a withholding agent to do beneficial owner reporting on Form 1042-S and payee reporting on Form 1099. Therefore, the regulations will be amended to require a withholding agent that has insufficient information to allocate a payment to treat that payment as made to an undocumented payee, unless the allocation information is received before the withholding agent is required to file (without regard to extensions) Forms 1042-S or Forms 1099. Therefore, if an unallocated payment paid to a foreign intermediary or foreign partnership (other than a withholding foreign partnership) is an amount subject to chapter 3 withholding, it will be treated as if it were paid to an undocumented foreign payee and will be subject to 30 percent withholding. If the unallocated payment paid to a foreign intermediary or foreign partnership (other than a withholding foreign partnership) is deposit interest under section 871(i)(2)(A) or short-term OID under section 871(g)(1)(B), it will be treated as if paid to a U.S. nonexempt recipient and subject to 31 percent withholding. If the unallocated payment paid to a foreign intermediary or foreign partnership (other than a withholding foreign partnership) is an amount not subject to chapter 3 withholding (other than deposit interest and short-term OID), and the payor knows that at least one payee of the foreign intermediary or foreign partnership is a U.S. nonexempt recipient, then the unallocated portion of the payment will be treated as paid to a nonexempt recipient and subject to 31 percent withholding. If the withholding agent has no amounts from which to withhold, because, for example, it has already paid the amounts to a payee, the withholding agent must satisfy its liability for the 30 or 31 percent amount either from other amounts it holds on behalf of the payee or from its own funds.

The Treasury and the IRS have also determined that it is inappropriate to report an unallocated payment as if it were made in its entirety to a person who may or may not be entitled to receive the entire amount. Therefore, the regulations will also be amended so that an unallocated payment will be reported on a Form 1042-S or Form 1099, as appropriate, sent to the nonqualified intermediary or foreign partnership in the name of an unknown recipient. Further, §§1.1441–1(b)(6) and 1.1441–5(c)(3)(v) of the regulations will be amended so that an intermediary or partnership that fails to provide allocation information is not relieved of its responsibility to file Forms 1042-S even if it has provided a withholding agent with a Form W-8IMY that has documentation from all of its account holders or partners attached and the withholding agent has withheld the appropriate amount. An intermediary or partnership that fails to provide allocation information for a U.S. nonexempt recipient that receives a reportable amount will also be required to file a Form 1099 with regard to reportable payments made to that U.S. nonexempt recipient.

B. *Accrued Interest and Original Issue Discount*

Under §1.1441–3(b)(2) of the final withholding regulations, a withholding agent is not required to withhold on interest that has accrued up to the date of a sale of a debt obligation when the sale occurs between two interest payment dates. This exception to withholding applies even if the amount is taxable under sections 871 or 881 because, for example, it does not qualify as portfolio interest. Moreover, the exception applies even though there is no documentation establishing that the beneficial owner of the obligation is a foreign person. Documentation may be required, however, for Form 1099 reporting or backup withholding under sections 6045, 6049, and 3406. The exception from withholding does not relieve the withholding agent from reporting on Form 1042-S under section 1.1461–1(c). Withholding is required, however, under §1.1441–3(b)(1) on the gross amount of interest payable on an interest payment date, regardless of whether the payment constitutes a return of capital or the payment of income, unless an exception to withholding, such as the portfolio interest exemption, applies.

By contrast, under §1.1441–2(b)(3), the accrued amount of original issue discount is subject to withholding when a foreign person sells, exchanges, or receives a payment on an original issue discount obligation unless an exemption from withholding applies. A withholding agent is required to withhold on OID, however, only if it has actual knowledge of the proportion of the payment that is taxable to the beneficial owner of the OID obligation. A withholding agent has actual knowledge of the taxable portion of the OID if it knows how long the beneficial owner has held the obligation, the terms of the obligation, and the extent to which the beneficial owner purchased the obligation at a premium. A withholding agent is treated as having knowledge if such information is reasonably available. The information is considered to be reasonably available to a withholding agent if the withholding agent maintains a direct account relationship with the beneficial owner of the obligation. However, a withholding agent must withhold, notwithstanding lack of knowledge, if the withholding agent must treat the payment as made to a foreign payee under the applicable presumption rules because the withholding agent cannot reliably associate the payment with documentation and the amount would qualify as portfolio interest if the withholding agent held such documentation.

Because of the similarities between OID and accrued interest on an obligation sold between interest payment dates, the IRS and Treasury believe that they should be treated similarly. Further, the IRS and Treasury are concerned that a withholding exemption for the sale of debt obligations between interest payment dates even in the absence of a beneficial owner Form W-8 provides an easy avenue for the avoidance of the documentation requirements imposed under the portfolio interest provisions of sections 871(h) and 881(c). As a result, the IRS and Treasury issued proposed regulation §1.1441–3(b)(2) (REG–114000–97, 62 F.R. 53503) which would change the accrued interest rule to conform to the OID rule. Under the proposed regulation, a withholding agent would be required to withhold on the accrued interest portion of the purchase price if it knows the amount of accrued interest. A withholding agent would be deemed to have knowledge of the amount of accrued interest if it had a direct account relationship with the holder of the security. Further, withholding would be required on accrued interest if the interest would qualify as portfolio interest but the withholding agent does not have the beneficial owner documentation required under the portfolio interest rules.

Commentors have raised objections to both the proposed accrued interest rules and to the final OID rules. Regarding the proposed accrued interest rules, they note that most sales of debt obligations of U.S. issuers occur as delivery versus payment (DVP) transactions. DVP transactions are settled quickly and the need to obtain documentation would prohibit quick settlement of transactions. Moreover, sales of debt obligations often take place through several tiers of intermediaries. Since the portfolio interest rules require beneficial owner documentation, each intermediary involved in a transaction, including those with no direct relationship to the beneficial owner, would need to obtain beneficial owner documentation.

Commentors also criticized the presumption that a withholding agent has the information to determine the amount of OID or accrued interest if it has a direct account relationship with the beneficial owner of an obligation. They contend that a direct account relationship does not ensure that a withholding agent will have the information necessary to determine the amount of withholding. For example, if securities were not acquired by the withholding agent for the beneficial owner but were transferred by the beneficial owner to an account with the withholding agent, the withholding agent may not know the holding period of the security or whether it was acquired at a premium.

In response to these comments, the IRS and Treasury intend to revise the regulations governing the treatment of OID and accrued interest on obligations sold between interest payment dates. Under the revised regulations, only a withholding agent that is required to obtain Form W-8 or other documentary evidence will be required to withhold and report on OID or accrued interest on obligations sold between interest payment dates. No withholding or reporting of OID and accrued interest will be required, however, provided that (1) a withholding agent that is required to obtain a Form W-8 or other documentary evidence obtains the Form W-8 or other documentary evidence and (2) the interest qualifies as portfolio interest or qualifies for a complete exemption from taxation under an income tax treaty. Further, if a withholding agent that is required to obtain Form W-8 or other documentary evidence obtains the Form W-8 or other documentary evidence, but the interest or OID does not qualify for the portfolio interest exemption or a complete exemption from taxation under an income tax treaty, withholding and reporting on accrued interest or OID will be required, but only if the withholding agent knows the amount of accrued interest or OID paid or the withholding agent knows, or has reason to know, that the person selling the obligation has a principal purpose to avoid U.S. tax.

A withholding agent will be required to obtain a Form W-8 or other documentation from a beneficial owner only if the withholding agent is the person who receives the proceeds from the sale or exchange of the obligation against delivery of the obligation or, if the obligation is being retired, the withholding agent is the person responsible for paying the holder, or crediting the holder's account, with the proceeds from the retirement. Notwithstanding the preceding sentence, a withholding agent will not be required to obtain a Form W-8 or other documentation if it is effecting the sale of an obligation for a broker, as defined in §1.6045–1(a)(1), and the withholding agent does not know, and does not have reason to know, that the broker is the beneficial owner of the obligation. In that case, only the broker will be required to obtain a Form W-8 or other documentary evidence.

A withholding agent will be treated as knowing the amount of accrued interest or OID only if it actually knows the seller's holding period of the obligation, the terms of the obligation, and the extent to which the obligation was acquired by the seller at a premium. A withholding agent will not be treated as having knowledge of these facts merely because it has a direct account relationship with the beneficial owner.

If a withholding agent that is required to obtain a Form W-8 or other documentation fails to do so or the withholding agent knows, or has reason to know, that the sale of an obligation is part of a plan to avoid withholding, it must withhold on the amount of accrued interest or OID determined under the following rules. If the amount subject to withholding is accrued interest, the amount of income subject to withholding is determined as if the seller's income is equal to the amount of interest due as of the next interest payment date pro rated to the date of sale. If the obligation is an original issue discount obligation, the amount of OID is determined by assuming that the seller has held the instrument since its original issuance. A withholding agent may rely on the most recently published "List of Original Issue Discount Instruments" (IRS Publication 1212) to determine the amount of OID in any particular transaction. If a withholding agent cannot determine the amount of OID subject to withholding under these rules, it must withhold an amount, based on the entire amount paid, that is necessary to assure that the tax withheld is not less than 30 percent of the amount that will subsequently be determined to be income subject to tax. See §1.1441–3(c)(4)(i)(A).

Finally, no change will be made to the rule under §1.1441–3(b)(1) that requires withholding on the gross amount of interest payable on an interest payment date, regardless of whether the payment constitutes a return of capital or the payment of income.

C. *Delayed Implementation of IRS-Certified TIN*

Under §1.1441–6(b), a withholding agent may rely on a claim that a beneficial owner is entitled to a reduced rate of withholding based on an income tax treaty only if the withholding agent can reliably associate the payment with a valid withholding certificate (Form W-8BEN). A withholding certificate is valid only if it contains a taxpayer identification number ("TIN"). Further, a TIN is valid to establish proof of residence in a treaty country only if the TIN is certified by the IRS. Under §1.1441–6(b)(2), a TIN is not required to appear on a withholding certificate if treaty benefits are claimed with respect to income from certain types of instruments, which, generally, are publicly traded. The procedures for obtaining a certified TIN are set forth in §1.1441–6(c)(2)(ii).

The IRS will not implement the procedure for obtaining certified TINs under §1.1441–6(c)(2)(ii) until January 1, 2002. Until the IRS begins to issue certified TINs, a withholding agent may treat a beneficial owner as a resident of a treaty country in situations in which a certified TIN would otherwise be required if the withholding agent has a Form W-8BEN from the beneficial owner that contains a TIN, the form contains a statement that the beneficial owner is a resident of a particular treaty country, the beneficial owner's permanent residence address on the form is in that treaty country, and the form is otherwise valid. If a beneficial owner provides a permanent residence address on the Form W-8BEN that is outside the applicable treaty country, the withholding agent may rely on the beneficial owner's claim for benefits under a particular treaty only if the withholding agent obtains, and may rely on, either a certificate of residence as described in §1.1441–6(c)(3) or the documentary evidence as described in §1.1441–6(c)(4) that establishes the beneficial owner's residence in the particular treaty country.

D. *Trusts and Estates.*

Sections 1.1441–1(c)(6)(i) and (ii)(A) generally treat the beneficial owner of income as the person that is the owner of the income under U.S. tax principles. For flow-through entities, which are defined to be partnerships, trusts, and estates, the beneficial owners are the persons who, under U.S. tax principles, are the owners of the income in their separate or individual capacities. Section 1.1441–1(e)(3)(i) states that a trust or estate is required to use a flow-through certificate, as defined in §1.1441–5(e), to provide the certificates or documentation on the status of the beneficiaries of a trust or estate. Section 1.1441–5(e), however, is reserved. These rules imply that, at least in some cases, the beneficial owners of income paid to a trust or estate are the beneficiaries of the trust or estate. Section 1.1441–1(c)(6)(ii)(B), however, states that the provisions of §1.1441–1(c)(6)(i) and (ii)(A) shall not apply to trusts or estates. Instead, the beneficial owner of income paid to a trust or estate is determined under §1.1441–3(f) and (g) of the regulations in effect prior to January 1, 1999 (see those sections as contained in 26 CFR part 1, revised April 1, 1997). Sections 1.1441–3(f) and (g), however, do not make beneficial owner determinations. Rather, they generally require withholding under section 1441 if the fiduciary of a trust or estate is a foreign person or, in the case of income taxable to a grantor under sections 671 through 679 of the Code, the trust is created by a nonresident alien individual.

Treasury and the IRS intend to issue regulations that will clarify the withholding obligations of income paid to trusts and estates. Under these rules, a foreign trustee or foreign executor of a U.S. or foreign trust or estate must furnish a withholding agent with a Form W-8IMY (Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for United States Tax Withholding). If the foreign person is considered a nonqualified intermediary and is the trustee of a trust described in section 651(a) or a trust, all or a portion of which is treated as owned by the grantor or other persons under sections 671 through 679, the trustee must attach the Forms W-8BEN, Forms W-8EXP, or, if required, Forms W-9, of the beneficiaries or grantors of the trust. In all other cases, the foreign trustee or executor must attach a Form W-8BEN, Form W-8EXP, or if required, Form W-9, completed on behalf of the trust or estate.

E. *Application of Negative Confirmation Rules to Existing Accounts.*

Section 1.6049–5(c)(4)(i) provides an exception from the normal documentation requirements for payments of amounts not subject to chapter 3 withholding (other than U.S. source OID on certain short-term obligations or U.S. source deposit interest) to an offshore account by a bank or other financial institution. Under that exception, if it is not customary to obtain documentary evidence, a payor may, instead of obtaining a withholding certificate or documentary evidence, rely on an account holder's declaration of foreign status made on an account opening statement if certain conditions are met. Under §1.6049–5(c)(4)(iv), if it is customary to obtain documentary evidence but it is not customary to renew it, then a payor must request such documentary evidence in lieu of a declaration of foreign status. For both the §§1.6049–5(c)(4)(i) and (iv) exceptions, the bank or financial institution must include a "negative confirmation" in a year-end statement mailed to the payee in which the bank or financial institution states that the payee is being treated as a non-U.S. person and that the payee has an obligation to notify the bank or financial institution if the payee becomes a U.S. citizen or resident.

Section 1.6049–5(c)(4)(v) states that the exceptions of §§1.6049–5(c)(4)(i) and (iv) do not apply to an account opened before January 1, 2000. Prior to January 1, 2000, the rules in §§35a.9999–3(ii) Q&A 34 and 35a.9999–4 Q&A 1 and 5 apply. Under those rules certain foreign payors may treat a payee as a foreign person if the payor has evidence in its records that the payee is a foreign person, including a written indication from the payee that the payee is not a U.S. person. By stating that the rules of §§1.6049–5(c)(4)(i) and (iv) do not apply to accounts opened before January 1, 2000, the regulations inadvertently exclude banks or financial institutions with accounts that have declarations of foreign status, or other documentary evidence of foreign status, from continuing to rely on those statements or documentation provided the bank or financial institution sends the negative confirmation required under §1.6049–5(c)(4)(iii). The rule of §1.6049–5(c)(4)(v) will be changed so that payors who relied on the rules contained in §§35a.9999–3(ii) Q&A 34 and 35a.9999–4 Q&A 1 and 5, as in effect prior to January 1, 2000, with regard to payments of foreign source interest or broker proceeds from sales effected outside the United States may continue to treat the payee as a foreign person under the rules of §1.6049–5(c)(4), provided that the payor sends a negative confirmation to the payee each year as required under §1.6049–5(c)(4)(iii) and does not know, or have reason to know, that the payee is a U.S. person.

*F. Expansion of Master Agreement/ Confirmation Exception for Notional Principal Contracts.* Under §1.1441– 4(a)(3) a withholding agent must treat a payment of income on a notional principal contract made to a foreign person as income effectively connected with the conduct of a trade or business within the United States unless the withholding agent can reliably associate the payment with a withholding certificate (Form W-8BEN) on which it can rely to treat the payment as an amount that is not effectively connected. An exception to the Form W-8BEN requirement is provided under §1.1441–4(a)(3)(ii). Under that section, a payment to a financial institution is not treated as effectively connected with the conduct of a trade or business within the United States if the foreign financial institution provides a representation in a master agreement that governs transactions in notional principal contracts between the parties (for example an International Swaps and Derivatives Association (ISDA) Agreement) or in the confirmation the particular notional principal contract transaction that the counterparty is a U.S. person or a non-U.S. branch of a foreign person.

Commentors have asked that the master agreement and confirmation exceptions be expanded to apply to persons other than financial institutions. The regulations will be changed so that persons other than financial institutions can use the master agreement and confirmation exceptions.

G. *Use of Documentary Evidence by Foreign Partnerships with U.S. Accounts.*

Under §1.6049–5(c)(1) a withholding agent or payor may generally rely on documentary evidence instead of a beneficial owner withholding certificate if an amount is paid outside the United States to an offshore account. An offshore account is an account maintained at an office or branch of a U.S. or foreign bank or other financial institution at any location outside the United States and outside of a U.S. possession. Under §1.6049-5(e), an amount is considered paid outside the United States if the payor completes the acts necessary to effect payment outside the United States.

The regulations do not specifically address whether partners of a foreign partnership that has an account in the United States can use documentary evidence to establish their foreign status. Under §1.1441–5(c)(1) it is the partners, and not the partnership, that are considered to be the payees on the amounts credited to an account. Thus, the regulations as currently drafted appear to preclude the use of documentary evidence by the foreign partners of a foreign partnership.

The regulations will be amended to permit foreign partners of a foreign partnership that has an account in the United States to use documentary evidence. As a result, such partners will be treated the same as foreign account holders of a financial institution that has an account in the United States.

H. *Withholding on Capital Gain Distributions of a Domestic Real Estate Investment Trust ("REIT").*

Section 1.1441–3(c)(4)(i)(C) requires withholding under section 1441 on the portion of a distribution from a REIT that is not designated as a capital gain dividend or a return of basis. Under section 1.1445–8(c), withholding is required under section 1445 on the portion of the distribution designated by a REIT as a capital gain dividend.

By stating that withholding is required on amounts not designated as a capital gain dividend or a return of basis, §1.1441–3(c)(4)(i)(C) requires withholding on a distribution in excess of basis, which under section 301(c)(3) is treated as capital gain from the sale or exchange of stock. The final withholding regulations will be amended to state that withholding under section 1441 is not required on a distribution in excess of basis (which under section 301(c)(3) is treated as a capital gain). However, a distribution in excess of basis is subject to withholding under section 1445 unless the interest in the REIT is not a U.S. real property interest (e.g. an interest in a domestically controlled REIT under section 897(h)(2)).

I. *Validity period for documentary evidence.*

Under §1.1441–1(e)(4)(ii), the documentary evidence that may be provided under §§1.1441–6(c)(4) and 1.6049–5(c)(1) remains valid until "the earlier of the last day of the third calendar year following the year in which the documentary evidence is created. . . ." Commentors have stated that it is not clear when documentary evidence is created. To clarify the rule, §1.1441–1(e)(4)(ii) will be amended to permit the validity period to be measured from the date documentation is provided to a withholding agent.

Section II. Model Qualified Intermediary Withholding Agreement.

A. *Submission of Know-Your-Customer Information.* Before a model QI withholding agreement will be concluded for any country, the Internal Revenue Service must receive certain information regarding that country's "know-your-customer" rules. This information is necessary to evaluate whether those rules are sufficient to establish an account holder's status as a beneficial owner or intermediary and the account holder's nationality and residence. If the "know-your-customer" rules are sufficient for these purposes, they will be incorporated, with any necessary modifications, into the Attachments to the qualified intermediary agreement. The information the IRS must receive is the following:

1. An English translation of the laws and regulations ("know-your-customer" rules) governing the requirements of QI to obtain documentation confirming the identity of QI's account holders. The translation must include the name of the law, and the appropriate citations to the law and regulations.
2. The name of the organization (whether a governmental entity or private association) responsible for enforcing the know-your customer rules. Specify how those rules are enforced (e.g., through audit) and the frequency of compliance checks.
3. The penalties that apply for failure to obtain, or evaluate, documentation under the know-your-customer rules.
4. The definition of customer or account holder that is used under the know-your-customer rules. Specify whether the definition encompasses direct and indirect beneficiaries of an account if the activity in the account involves the receipt or disbursal of funds. Specify whether the definition of customer or account holder includes a trust beneficiary, a company whose assets are managed by an asset manager, a controlling shareholder of a closely held corporation or the grantor of a trust.
5. A statement regarding whether the documentation required under the know-your-customer rules requires QI to determine if its account holder is acting as an intermediary for another person.
6. A statement regarding whether the documentation required under the know-your-customer rules requires QI to identify the account holder as a beneficial owner of income credited to an account.
7. A list of the specific documentation required to be used under the know-your-customer rules, or if those rules do not require use of specific documentation, the documentation that is generally accepted by the authorities responsible for enforcing those rules.
8. A statement regarding whether the know-your-customer rules require that an account holder provide a permanent residence address.
9. A summary of the rules that apply if an account is not opened in person (e.g., correspondence, telephone, Internet).
10. Whether an account holder's identity may be established, in whole or in part, by introductions or referrals.
11. The circumstances under which new documentation must be obtained, or existing documentation verified, under the know-your-customer rules.
12. A list of all the exceptions, if any, to the documentation requirements under the know-your-customer rules.
13. A statement regarding whether the know-your-customer rules do not require documentation from an account holder if a payment to or from that account holder is cleared by another financial institution.[1]
14. A statement regarding how long the documentation remains valid under the know-your customer rules.
15. A statement regarding how long the documentation obtained under the know-your-customer rules must be retained and the manner for maintaining that documentation.
16. Specify whether the rules require the maintenance of wire transfer records, the form of the wire transfer records and how long those records must be maintained. State whether the wire transfer records require information as to both the original source of the funds and the final destination of the funds.
17. A list of any payments or types of accounts that are not subject to the know-your-customer rules.
18. Specify whether there are special rules that apply for purposes of private banking activities.

[1]The IRS will not permit a QI to establish the identity of an account holder without obtaining documentation directly from the account holder.

B. *Proposed Qualified Intermediary Agreement*

**SECTION 1. PURPOSE AND SCOPE**

Sec. 1.01. General Obligations.
Sec. 1.02. Parties to the Agreement.
Sec. 1.03. Documentation Retention
Sec. 1.04. Qualified Intermediary Withholding Certificate
Sec. 1.05. Disclosure of Account Holders.
Sec. 1.06. Classes of Assets.
Sec. 1.07. Withholding Obligations
Sec. 1.08. Return Obligations
Sec. 1.09. Information Reporting Obligations
Sec. 1.10. Adjustments for Over- and Under- Withholding and Refunds
Sec. 1.11. External Audit

**SECTION 2. DEFINITIONS**

Sec. 2.01. Account Holder
Sec. 2.02. Agreement

**THIS AGREEMENT** is made in duplicate under and in pursuance of section 1441 of the Internal Revenue Code of 1986, as amended, (the "Code") and Treasury Regulation §1.1441–1(e)(5) by and between [name of QI], any affiliated entities of QI designated in Appendix A of this Agreement that are signatories to this Agreement (collectively referred to as "QI"), and the INTERNAL REVENUE SERVICE (the "IRS"):

**WHEREAS,** QI has submitted an application in accordance with Revenue Procedure 98–27 to be a qualified intermediary for purposes of Treas. Reg. §1.1441–1(e)(5);

**WHEREAS,** QI and the IRS desire to enter into an agreement to establish the documentation, withholding, information reporting, tax return filing, deposit obligations, and refund procedures of QI under sections 1441, 1442, 1443, 1461, 3406, 6041, 6042, 6044, 6045, 6049, 6050N, 6302, 6402, 6413, and 6414 of the Code with respect to certain types of payments;

**NOW, THEREFORE,** in consideration of the following terms, representations, and conditions, the parties agree as follows:

## SECTION 1. PURPOSE AND SCOPE

**Sec. 1.01. General Obligations.** QI is a withholding agent under chapter 3 of the Code and a payor under chapter 61 and section 3406 of the Code for amounts that it pays to its account holders. Except as otherwise provided in this Agreement, QI's obligations with respect to amounts it pays to account holders are governed by chapter 3, chapter 61, and section 3406 of the Code and the regulations thereunder. QI shall act in its capacity as a qualified intermediary pursuant to this Agreement only for those accounts QI has with a withholding agent that QI has designated as accounts for which it acts as a qualified intermediary. QI is not required to act as a qualified intermediary for all accounts that it has with a withholding agent. However, if QI designates an account as one for which it will act as a qualified intermediary, it must act as a qualified intermediary for all payments made to that account.

**Sec. 1.02. Parties to the Agreement. This Agreement applies to:**

(a) All offices of QI located in the countries described in Appendix A of this Agreement;
(b) All of the offices of the affiliated entities of QI that are signatories to this Agreement that are located in the countries described in Appendix A of this Agreement; and
(c) The Internal Revenue Service.

Appendix A may be amended, in writing, with the agreement of the IRS. Such amendments shall become part of this Agreement.

**Sec. 1.03. Documentation Retention.** QI agrees to obtain documentation from its account holders, and maintain and retain such documentation, as provided in section 5 of this Agreement.

**Sec. 1.04. Qualified Intermediary Withholding Certificate.** QI agrees to provide each withholding agent from which QI receives reportable amounts as a qualified intermediary with a qualified intermediary withholding certificate in accordance with section 6 of this Agreement. A qualified intermediary withholding certificate is a Form W-8IMY.

**Sec. 1.05. Disclosure of Account Holders.** Except as specifically required under section 6 of this Agreement, QI is not required to disclose the identities of its account holders to a withholding agent to whom it provides a Form W-8IMY. Therefore, the documentation given by an account holder to QI does not have to be attached to QI's Form W-8IMY, except as specifically provided in section 6 of this Agreement.

**Sec. 1.06. Classes of Assets.** QI agrees to provide each withholding agent information regarding the classes of assets determined in accordance with section 7 of this Agreement.

**Sec. 1.07. Withholding Obligations.** QI agrees to withhold under sections 1441, 1442, 1443, 1461, and 3406 of the Code to the extent provided in sections 3 and 8 of this Agreement.

**Sec. 1.08. Return Obligations.** QI agrees to file Forms 945 and 1042 as provided in section 9 of this Agreement.

**Sec. 1.09. Information Reporting Obligations.** QI agrees to file Forms 1042-S, 1096, and 1099 as provided in section 10 of this Agreement.

**Sec. 1.10. Adjustments for Over- and Under-Withholding and Refunds.** QI agrees to follow the procedures for over- and under-withholding and for claiming refunds, as provided in section 11 of this Agreement.

**Sec. 1.11. External Audit.** QI agrees to the external audit procedures provided in section 12 of this Agreement.

## SECTION 2. DEFINITIONS

For purposes of this Agreement, the terms listed below are defined as follows:

**Sec. 2.01. Account Holder.** An "account holder" means any person that has an account with a qualified or nonqualified intermediary. Unless the context otherwise requires, an account holder includes another intermediary (e.g., custodian, nominee or other agent) that has an account with the qualified or nonqualified intermediary (whether the other intermediary is acting as a qualified intermediary, nonqualified intermediary, or private arrangement intermediary) and any person who has an account with the other intermediary. The term includes both beneficial owners as defined in Treas. Reg. §1.1441–1(c)(6) and payees as determined under chapters 3 and 61 of the Code. Thus, for example, an account holder may include the owners of an entity classified as a partnership under U.S. tax principles that holds an account with a qualified or nonqualified intermediary.

**Sec. 2.02. Agreement.** "Agreement" means this agreement, all appendices and attachments to this agreement, and QI's application to be a qualified intermediary. All such appendices, attachments, and QI's application are incorporated into this Agreement by reference.

**Sec. 2.03. Assumption of Withholding Responsibility.** A QI that assumes primary withholding responsibility under chapter 3, or assumes reporting and withholding responsibility under chapter 61 and section 3406 of the Code, assumes the primary responsibility for deducting, withholding, and depositing the appropriate amount from a payment. Generally, a qualified intermediary's assumption of primary withholding responsibility under chapter 3 of the Code, or the assumption of backup withholding responsibility under section 3406 of the Code, relieves the person who makes a payment to the qualified intermediary from the responsibility to withhold.

**Sec. 2.04. Bank Deposit Interest.** "Bank deposit interest" means interest described in section 871(i)(2)(A) of the Code.

**Sec. 2.05. Beneficial Owner.** A "beneficial owner" has the meaning given to that term in Treas. Reg. §1.1441-1(c)(6) and, if treaty benefits are claimed, Treas. Reg. §1.894–1T(d)(2)(ii).

**Sec. 2.06. Chapter 3 of the Code.** Any reference to "chapter 3 of the Code" means sections 1441, 1442, 1443, 1461, 1463, and 1464 of the Code.

**Sec. 2.07. Chapter 61 of the Code.** Any reference to "chapter 61 of the Code" means sections 6041, 6041A, 6042, 6044, 6045, 6050N, and 6050P of the Code.

**Sec. 2.08. Class of Assets.** "Class of assets" has the meanings given to the terms in sections 7 and 10 of this Agreement.

**Sec. 2.09. Documentary Evidence.** "Documentary evidence" means any documentation obtained pursuant to section 5 of this Agreement other than a Form W-8 or Form W-9.

**Sec. 2.10. Documentation.** "Documentation" means any valid Form W-8, Form W-9, or documentary evidence obtained pursuant to section 5 of this Agreement.

**Sec. 2.11. Documented Account Holder/Payee.** A "documented account holder" or "documented payee" is an account holder or payee for whom QI has obtained documentation pursuant to section 5 of this Agreement.

**Sec. 2.12. Exempt Recipient.** An "exempt recipient" means, for interest, dividends, and royalties, a person described in Treas. Reg. §1.6049–4(c)(1)(ii). For broker proceeds, an exempt recipient is a person described in Treas. Reg. §§5f.6045-1(c)(3)(i)(B) or 1.6045–2(b)(2)(i).

**Sec. 2.13. External Auditor.** An "external auditor" is the auditor designated as QI's (or any private arrangement intermediary's) external auditor in Appendix B of this Agreement.

**Sec. 2.14. Foreign Person.** A "foreign person" is any person that is not a "United States person" and includes a "nonresident alien individual," a "foreign corporation," a "foreign partnership," a "foreign trust," and a "foreign estate," as those terms are defined in section 7701 of the Code. Notwithstanding the preceding sentence, the term foreign person also includes a foreign branch of a U.S. person that provides QI with a qualified intermediary Form W-8IMY.

**Sec. 2.15. Form W-8.** "Form W-8" means IRS Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding; IRS Form W-8ECI, Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States; IRS Form W-8EXP, Certificate of Foreign Governments and Other Foreign Organizations for United States Tax Withholding; and Form W-8IMY, Certificate of Foreign Intermediary, Foreign Partnership, and Certain U.S. Branches for United States Tax Withholding, as appropriate, or any acceptable substitute form.

**Sec. 2.16. Form W-9.** "Form W-9" means IRS Form W-9, Request for Taxpayer Identification Number and Certification, or any acceptable substitute.

**Sec. 2.17. Form 945.** "Form 945" means IRS Form 945, Annual Return of Withheld Federal Income Tax.

**Sec. 2.18. Form 1042.** "Form 1042" means an IRS Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.

**Sec. 2.19. Form 1042-S.** "Form 1042-S" means an IRS Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding.

**Sec. 2.20. Form 1042-S Reporting.** "Form 1042-S reporting" means the reporting required on Form 1042-S.

**Sec. 2.21. Form 1096.** "Form 1096" means IRS Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

**Sec. 2.22. Form 1099.** "Form 1099" means IRS Form 1099-B, Proceeds From Broker and Barter Exchange Transactions; IRS Form 1099-DIV, Dividends and Distributions; IRS Form 1099-INT, Interest Income; IRS Form 1099-MISC, Miscellaneous Income; IRS Form 1099-OID, Original Issue Discount, and any other form in the IRS Form 1099 series appropriate to the type of payment required to be reported.

**Sec. 2.23. Form 1099 Reporting.** "Form 1099 reporting" means the reporting required on Form 1099.

**Sec. 2.24. Intermediary.** An "intermediary" means any person that acts on behalf of another person such as a custodian, broker, nominee, or other agent.

**Sec. 2.25. Non-Exempt Recipient.** A "non-exempt recipient" or "non-exempt payee" means a person that is not an exempt recipient under the definition in paragraph 2.12 of this section.

**Sec. 2.26. Nonqualified Intermediary.** A "nonqualified intermediary" is any intermediary that is not a qualified intermediary.

**Sec. 2.27. Payee.** A "payee" is the person described in Treas. Reg. §§1.1441–1(b)(2) and b(3); 1.1441–5(c), (d) and (e); and 1.6049–5(d).

**Sec. 2.28. Payment.** A "payment" is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. See Treas. Reg. §1.1441–2(e). For example, a payment includes crediting an amount to an account.

**Sec. 2.29. Payor.** A "payor" means a person, including a middleman treated as a payor, required to make an information return under chapter 61 of the Code. See Treas. Reg. §§1.6049–4(a)(2) and 31.3406(a)–2.

**Sec. 2.30. Presume.** "Presume" means the presumptions that a person must make under Treas. Reg. §§1.1441–1(b)(3), 1.1441–4(a), 1.1441–5(d), 1.1441–5(e), 1.1441–9(b)(3) and 1.6049–5(d).

**Sec. 2.31. Private Arrangement Intermediary.** A "private arrangement intermediary" or "PAI" is an intermediary described in section 4 of this Agreement.

**Sec. 2.32. Qualified Intermediary.** A "qualified intermediary" is a person, described in Treas. Reg. §1.1441-1(e)(5)(ii), that enters into a withholding agreement with the IRS to be treated as a qualified intermediary.

**Sec. 2.33. Qualified Intermediary (QI) EIN.** A "qualified intermediary EIN" or "QI-EIN" means the employer identification number assigned by the IRS to a qualified intermediary to be used solely in its capacity as a qualified intermediary.

**Sec. 2.34. Reduced Rate of Withholding.** A "reduced rate of withholding" means a rate of withholding under chapter 3 of the Code that is less than 30% and includes an exemption from withholding.

**Sec. 2.35. Reportable Amount.** A "reportable amount" means an amount subject to withholding under chapter 3 of the Code (within the meaning of Treas. Reg. §1.1441–2(a)), U.S. source deposit interest (including original issue discount) described in section 871(i)(2)(A) of the Code, and U.S. source interest or original issue discount on short-term obligations described in section 871(g)(1)(B) of the Code. The term does not include payments on deposits with banks and other financial institutions that remain on deposit for two weeks or less. It also does not include amounts of original issue discount arising from a sale and repurchase transaction completed within a period of two weeks or less, or amounts described in Treas. Reg. §1.6049–5(b)(7), (10), or (11) (relating to certain obligations issued in bearer form). See Treas. Reg. §1.1441–1(e)(3)(vi).

**Sec. 2.36. Reportable Payment.** A "reportable payment" means any payment described in section 3406(b) of the Code. For example, reportable payments include reportable amounts, as defined in section 2.35 of this Agreement, and, in addition, broker proceeds, foreign source interest, foreign source dividends, and foreign source royalties unless an exception to reporting applies under chapter 61 of the Code.

**Sec. 2.37. Short-Term Obligation.** A "short-term obligation" is any obligation described in section 871(g)(1)(B)(i) of the Code.

**Sec. 2.38. U.S. Person.** A "United States (or U.S.) person" is a person described in section 7701(a)(30) of the Code, the U.S. government (including an agency or instrumentality thereof), a State of the United States (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof).

**Sec. 2.39. Undocumented Account Holder/Payee.** An "undocumented account holder" or "undocumented payee" is an account holder or payee for whom QI has not obtained documentation in accordance with section 5 of this Agreement.

**Sec. 2.40. Withholding Agent.** A "withholding agent" has the same meaning as set forth in Treas. Reg. §1.1441-7(a) and includes a payor, as defined in section 2.29 of this Agreement. As used in this Agreement, the term generally refers to the person making a payment to a qualified intermediary.

**Sec. 2.41. Other Terms.** Any term not defined in this section has the same meaning that it has under the Code, the Income Tax Regulations, or any applicable income tax treaty.

## SECTION 3. WITHHOLDING RESPONSIBILITY UNDER SECTION 1441, 1442, AND 1443

**Sec. 3.01. Withholding Responsibility.** QI is subject to the withholding and reporting provisions applicable to withholding agents and payors under chapters 3, 61, and section 3406 of the Code. QI shall not, however, be required to withhold tax under sections 1441, 1442, and 1443 from any payment of a reportable amount received from a withholding agent, provided that the withholding agent withheld the proper amount of tax.

**Sec. 3.02. Assumption of Chapter 3 Primary Withholding Responsibility.** QI, upon agreement with a withholding agent, may assume primary withholding responsibility under chapter 3 of the Code for a reportable amount paid by the withholding agent to an account QI has with the withholding agent by providing the withholding agent a Form W-8IMY on which QI designates the account to which the amount is paid as one for which it assumes primary withholding responsibility. QI is not required to assume primary withholding responsibility for all accounts it has with the withholding agent. However, if QI assumes primary withholding responsibility under chapter 3 of the Code for any account, it must assume that responsibility for all payments of reportable amounts made by the withholding agent to that account. QI may assume primary withholding responsibility under chapter 3 of the Code without informing the IRS. See section 8.04 of this Agreement for QI's responsibilities to the extent it has assumed Form 1099 reporting responsibility and backup withholding.

*[Use section 3.03, below, if QI is not eligible or does not assume backup withholding and Form 1099 reporting responsibility. A QI is not eligible to assume primary backup withholding and chapter 61 reporting responsibility if it is a foreign person that does not have a branch in the U.S. capable of adequately fulfilling the obligations imposed under chapter 61 and section 3406 of the Code. ]*

**Sec. 3.03. No Assumption of Form 1099 Reporting and Backup Withholding Responsibility.** Notwithstanding section 3.01 of this Agreement, QI may not assume Form 1099 reporting responsibility or backup withholding responsibility under section 3406 of the Code in lieu of furnishing a withholding agent with a U.S. non-exempt recipient account holder's Form W-9, or other information regarding the account holder. Therefore, QI must furnish the withholding agent with a U.S. non-exempt recipient's Form W-9, or other information in accordance with section 6 of this Agreement, and separately identify the assets associated with such recipient as required under section 7 of this Agreement.

*[Use section 3.03, below, if QI does assumes Form 1099 reporting and backup withholding responsibility.]*

**Sec. 3.03. Assumption of Form 1099 Reporting and Backup Withholding Responsibility.**

[QI maintains the following branch [name and U.S. address] in the United States and represents that the branch can fulfill the Form 1099 reporting obligations and backup withholding obligations of a payor under chapter 61 and section 3406 of the Code].[2]

or

[QI is a foreign branch of a U.S. financial institution].[3]

QI assumes Form 1099 reporting responsibility under chapter 61 of the Code and backup withholding responsibility under section 3406 of the Code for reportable payments made to an account QI has with the withholding agent in lieu of furnishing the withholding agent with a U.S. non-exempt recipient account holder's Form W-9, or, in absence of a Form W-9, information regarding the account holder's name, address, and taxpayer identification number, if any. QI shall assume such reporting and withholding obligations by attaching a statement to a Form W-8IMY on which QI designates the account it has with the withholding agent for which it assumes such obligations. QI is not required to assume Form 1099 reporting and backup withholding responsibility for all accounts it has with the withholding agent. However, if QI assumes Form 1099 reporting and backup withholding responsibility for any account, it must assume that responsibility for all reportable payments made by the withholding agent to that account. See section 8.04 of this Agreement for QI's responsibilities to the extent it has assumed Form 1099 reporting responsibility and backup withholding.

**Sec. 3.04. Requirements of QI Assuming Reporting and Withholding Responsibility Under Sections 3.02 and/or 3.03.** If QI assumes primary withholding responsibility under chapter 3 of the Code or assumes Form 1099 reporting and backup withholding responsibility for payments received from a withholding agent in accordance with sections 3.02 and/or 3.03 of this Agreement, then–

(A) QI shall assume that responsibility for all other intermediaries (whether qualified or nonqualified) that may precede QI in the chain of payment, but

(B) QI shall not be required to withhold on any payment made to another qualified intermediary that follows QI in the chain of payment and that has assumed primary withholding responsibility for that payment.

## SECTION 4. PRIVATE ARRANGEMENT INTERMEDIARIES

**Sec. 4.01. In General.** QI may enter into a private arrangement with another intermediary under which the other intermediary agrees to perform all of the obligations of QI under this Agreement, except as provided in section 4.02 of this Agreement. Such agreement shall be between the QI and all the offices of the other intermediary located in a specified country. The specified country must be one for which there is a model qualified intermediary agreement available. Such an intermediary is referred to in this Agreement as a private arrangement intermediary ("PAI"). By entering into a PAI agreement, QI is not assigning its liability for the performance of any of its obligations under this Agreement. Therefore, QI shall remain liable for any tax, penalties, interest, and any other sanction that may result from the failure of the PAI to meet any of the obligations imposed by its agreement with QI. QI shall assert no defenses against the IRS for the failures of the PAI that the PAI may assert against QI. For purposes of this Agreement, the PAI's actual knowledge or reason to know of facts relevant to withholding or reporting shall be imputed to QI. QI's liability for the failures of the PAI shall apply even though the PAI is itself a withholding agent under chapter 3 of the Code and a payor under chapter 61 and section 3406 and is itself separately liable for its failure to meet its obligations under the Internal Revenue Code. The PAI is not required to enter into an agreement with the IRS. For purposes of this Agreement, an intermediary shall be considered a PAI only if the following conditions are met:

**(A)** The PAI is, pursuant to a written agreement between QI and the PAI, subject to all the obligations of QI under this Agreement, except to the extent modified by section 4.02 of this Agreement;

**(B)** QI files a notice with the Assistant Commissioner (International), at the address set forth in section 14.06 of this Agreement, before the first payment for which the intermediary acts as a PAI giving the name, address, taxpayer identification number, if any, of the intermediary, and the name of the country or countries in which the offices of the PAI are located;

**(C)** The PAI is subject to the identical external audit procedures that apply to QI under this Agreement and the PAI uses the same external auditor designated as QI's external auditor in Appendix B of this Agreement, or another auditor approved by the IRS for that PAI, before the agreement between QI and the PAI is executed; and

**(D)** The PAI furnishes QI with a Form W-8IMY described in paragraph (C) of section 5.09 of this Agreement.

**Sec. 4.02. Modification of Obligations for PAI Agreements.** The agreement between QI and the PAI must provide that QI shall include in its Forms 945, 1042, 1099, and 1042-S all payments made by QI to designated accounts the PAI has with QI as if QI had

[2] This language is to be used by a foreign QI with a U.S. branch.
[3] This language is to be used by a QI that is a foreign branch of a U.S. person.

made those payments directly to the PAI's account holders. QI shall require the PAI to provide QI with all the information necessary for QI to meet its withholding and reporting obligations under chapters 3, 61, and section 3406 of the Code. No provisions shall be contained in the agreement between QI and a PAI that preclude, and no provisions of this Agreement shall be construed to preclude, the PAI's joint and several liability for tax, penalties, and interest under chapters 3, 61, and section 3406 to the extent that under-withholding, penalties, and interest have not been collected from QI. QI's agreement with the PAI must require the PAI to disclose any beneficial owner or payee information that QI is required to disclose to the IRS or a withholding agent under this Agreement. Nothing in the agreement between QI and the PAI shall permit the PAI to assume primary withholding responsibility under chapter 3 or assume Form 1099 reporting and section 3406 withholding obligations.

**Sec. 4.03. Termination of Arrangement.** QI shall cease to treat an intermediary as a PAI within 90 days of learning that the PAI is in default of its agreement with QI unless the PAI has cured the event of default prior to the expiration of such 90 day period. QI must provide the IRS with notice of any PAI agreement that has been terminated within 30 days of the termination.

## SECTION 5. DOCUMENTATION REQUIREMENTS

**Sec. 5.01. Documentation Required For Withholding Rate Reduction.** QI shall not reduce the rate of withholding, or instruct a withholding agent to reduce the rate of withholding, that applies under the presumption rules to a payment of a reportable amount unless QI can reliably associate the payment, within the meaning of Treas. Reg. §1.1441–1(b)(2)(vii), with valid documentation described in this section 5. QI shall obtain, review, and maintain documentation in accordance with this section 5 and, for documentary evidence, in accordance with the laws and procedures set forth in the Attachments to this Agreement. QI shall make Forms W-8, Forms W-9, and documentary evidence (together with any attachments to those documents) available upon request for inspection by the external auditor designated in Appendix B of this Agreement. See section 5.13 of this Agreement if documentation for an account holder is lacking or unreliable.

**Sec. 5.02. Reliance on Forms W-8 or W-9.** Subject to the due diligence procedures described in section 5.11 of this Agreement, QI may rely upon a valid Form W-8 or Form W-9 furnished by an account holder to determine whether the account holder is a foreign or U.S. person, and, if appropriate, whether the account holder is entitled to a reduced rate of withholding.

**Sec. 5.03. Documentary Evidence.** In lieu of relying on a Form W-8, QI may determine whether an account holder that is a beneficial owner is a foreign person on the basis of documentary evidence of the type described in the Attachments to this Agreement. QI may not, however, rely on documentary evidence for those persons described in sections 5.06, 5.07, 5.08, and 5.09 of this Agreement. Reliance on documentary evidence is subject to the due diligence requirements of section 5.11 of this Agreement. Documentary evidence may also form the basis for a foreign beneficial owner's claim to a reduced rate of withholding under an income tax treaty, provided that the documentation is supplemented with a statement described in section 5.04 of this Agreement, and provided that a taxpayer identification number is obtained when required pursuant to section 5.05 of this Agreement. Documentary evidence need not be obtained under penalties of perjury. QI shall notify the IRS of any changes (whether or not material) in the laws and procedures set forth in the Attachments to this Agreement. QI may also rely upon documentary evidence to determine if an account holder is a U.S. exempt recipient. Nothing in this section 5.03, however, shall relieve QI of the responsibility for obtaining Form W-9 from account holders that are U.S. non-exempt recipients.

**Sec. 5.04. Limitation on Benefits and Section 894 Representations.** If an account holder that is a beneficial owner (other than an individual) claims, based on documentary evidence, entitlement to a reduced rate of withholding under an income tax treaty, QI must obtain a statement that the account holder meets the Limitation on Benefits article, if any, contained in the applicable income tax treaty. In addition, the account holder must state that it derives the income within the meaning of Treas. Reg. §1.894-1T(d) for which it claims a treaty benefit as a resident of the applicable treaty country, it is the beneficial owner of that payment, and that it meets all other applicable requirements for the benefits claimed. The statements need not be made under penalties of perjury and may be made as part of an account opening statement.

**Sec. 5.05. TIN Requirement.** Notwithstanding Treas. Reg. §1.1441–6(b)(1), providing that a withholding agent must require a taxpayer identification number before reducing the rate of withholding on certain payments, QI shall require a taxpayer identification number only for those account holders who meet the criteria for disclosure as set forth in section 10.02(D) of this Agreement.

**Sec. 5.06. Documentation for International Organizations.** QI shall treat an account holder as an international organization (as defined under section 7701(a)(18) of the Code), exempt from taxation under section 892 of the Code only if it obtains a Form W-8EXP or if the account holder's name is one that is designated as an international organization by executive order pursuant to 22 United States Code 288 through 288(f) and other facts surrounding the transaction reasonably indicate that the international organization is the beneficial owner of the payment.

**Sec. 5.07. Documentation for Foreign Governments.** QI shall treat an account holder as a foreign government or foreign central bank of issue exempt from taxation under section 892 or 895 of the Code, only if it has obtained a Form W-8EXP from the account holder.

**Sec. 5.08. Documentation for Foreign Tax-Exempt Organizations.** QI shall treat an account holder as a foreign organization exempt from tax under section 501(c) of the Code or, if a foreign private foundation, subject to withholding at a 4 percent rate under section 1443(b) of the Code, only if QI obtains a Form W-8EXP from the account holder. Further, QI shall treat a foreign organization as tax-exempt pursuant to a treaty only if QI obtains a Form W-8BEN from the organization.

**Sec. 5.09. Documentation From Intermediaries.** QI shall obtain the following documentation from any person that is an intermediary or foreign partnership:

**(A) Nonqualified Intermediaries and Foreign Partnerships (Other Than Withholding Foreign Partnerships).** If the account holder is a nonqualified intermediary or a foreign partnership (other than a withholding foreign partnership), QI shall obtain from the nonqualified intermediary or foreign partnership a Form W-8IMY (as required under Treas. Reg. § 1.1441–1(e)(3)(iii)). QI may rely on the Form W-8IMY, and the attachments to that form, received from the nonqualified intermediary or foreign partnership as the basis for the information that QI furnishes to a withholding agent under section 7 of this Agreement.

**(B) Qualified Intermediaries and Withholding Foreign Partnerships.** If the account holder is a qualified intermediary or withholding foreign partnership, QI shall obtain from the qualified intermediary or withholding foreign partnership a Form W-8-IMY (as required under Treas. Reg. §1.1441–1(e)(3)(ii) or §1.1441–5(c)(2)(iv)). QI may rely upon the Form W-8IMY, and the attachments to that form, received from the qualified intermediary or withholding foreign partnership as the basis for the information that QI furnishes to a withholding agent under section 7 of this Agreement. QI is not required to obtain documentation from the qualified intermediary or withholding foreign partnership's account holders.

**(C) Private Arrangement Intermediaries.** If QI has an agreement with a PAI, the PAI shall furnish QI a Form W-8IMY completed as if it were a qualified intermediary, with the exception that the PAI must not provide a QI-EIN on the Form W-8IMY. Further, the PAI must attach to its Form W-8IMY a statement that provides the information required under section 10 rather than section 7 of this Agreement. QI may rely on the Form W-8IMY, and the attachments to that form, received from the PAI as the basis for the information that QI furnishes to a withholding agent under section 7 of this Agreement. QI is not required to obtain documentation from the PAI's account holders.

**Sec. 5.10. Documentation Validity Period.** QI may rely on a Form W-8 until its validity expires under Treas. Reg. §1.1441-1(e)(4)(ii). QI may rely on a Form W-9 as long as it may reasonably rely on the form under the rules of Treas. Reg. §31.3406(h)-3(e). QI may rely on documentary evidence obtained in accordance with this section 5 for as long as the documentary evidence remains valid under the laws and procedures set forth in the Attachments to this Agreement, or until QI knows, or has reason to know, that the information contained in the documentary evidence is incorrect.

**Sec. 5.11. Due Diligence Requirements. (A) In General.** QI may rely on documentation provided to it by an account holder unless and until QI has actual knowledge or reason to know that the information or statements contained in the documentation are unreliable or incorrect. If QI discovers that information contained in documentation is unreliable or incorrect, or if QI discovers it has not conveyed information contained in documentation accurately to a withholding agent, QI must provide the corrected information to the withholding agent, to the extent necessary for the withholding agent to make any changes to QI's classes of assets, within 30 days after QI discovers that the information or statement is unreliable or incorrect. See section 8.01 of this Agreement for QI's responsibility to withhold on amounts for which QI knows, or has reason to know, that the withholding agent underwithheld. If QI receives notification from the IRS that claim of U.S. or foreign status, or, if applicable, a reduced rate of withholding, is incorrect, QI is treated as having actual knowledge on the date that is 30 calendar days after the date it receives the notice.

**(B) Reason to know.** QI shall be considered to have reason to know that relevant facts or statements contained in documentation are unreliable or incorrect if a reasonably prudent person in the position of a withholding agent would question the claims made.

**(C) Limitation on Reason to Know.** For payments described in this section 5.11(C), QI has reason to know that documentation is not reliable only if any one or more of the circumstances described in Treas. Reg. §1.1441–7(b)(2)(ii) exist. QI may rely upon the documentation, however, if additional documentation is provided that supports the account holder's claims. This paragraph (C) applies to the following types payments:

- Dividends and interest from stocks and debt obligations that are actively traded within the meaning of section 1092(d) of the Code;
- Dividends from any redeemable security issued by an investment company registered under the Investment Company Act of 1940 (15 United States Code 80a-1);
- Dividends, interest, or royalties from units of beneficial interest in a unit investment trust that are (or were upon issuance) publicly offered and are registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 United States Code 77a); and
- Amounts paid with respect to loans of the securities described above.

**Sec. 5.12. Maintenance, and Retention of Documentation.**

**(A) Maintaining Documentation.** QI shall maintain documentation by retaining the original, certified copy, photocopy, or microfiche or similar means of record retention of the documentation and noting in its records the date on which, and by whom, the document was received and reviewed.

**(B) Retention Period.** QI shall retain an account holder's documentation obtained under this section 5 (other than Form W-9) until the expiration of the statute of limitations for the assessment of tax under section 6501 of the Code has expired for the Form 1042 that includes a payment made to that account holder. QI shall retain an account holder's Form W-9 for the period specified in Treas. Reg. §31.3406(h)–3(g).

**Sec. 5.13. Application of Presumption Rules.** QI shall apply the presumption rules of Treas. Reg. §§ 1.1441-1(b)(3), 1.1441-4(a), 1.1441–5(d) and (e), 1.1441–9(b)(3) and 1.6049–5(d) to payments made to an account holder for whom it holds no documentation or holds documentation on which it can not rely.

## SECTION 6. QUALIFIED INTERMEDIARY WITHHOLDING CERTIFICATE AND DISCLOSURE OF ACCOUNT HOLDERS TO WITHHOLDING AGENT

**Sec. 6.01. Certification to Withholding Agent.** QI shall furnish a qualified intermediary withholding certificate to each withholding agent from which it receives a reportable amount from an account for which it acts as a qualified intermediary. The qualified intermediary withholding certificate is a Form W-8IMY that certifies QI is acting as a qualified intermediary and that contains QI's qualified intermediary EIN. QI shall provide the withholding agent a statement associated with Form W-8IMY that designates those accounts for which QI acts as a qualified intermediary and sufficient information regarding classes of assets as determined under section 7 of this Agreement for the withholding agent to determine the correct withholding and reporting on amounts paid to those accounts. The attached statement shall also clearly identify those accounts for which QI assumes primary withholding responsibility under chapter 3 of the Code and/or those accounts for which QI assumes Form 1099 reporting and backup withholding responsibility. The statement shall be updated as often as necessary for the withholding agent to meet its reporting and withholding obligations under chapters 3, 61, and section 3406 of the Code.

**Sec. 6.02. Disclosure of Certain Account Holder Documentation.** QI shall be required to disclose to the withholding agent the Form W-9 obtained from each U.S. non-exempt recipient account holder that receives reportable amounts to the extent QI does not assume Form 1099 reporting and backup withholding responsibility for the account. If QI has not obtained a Form W-9 from the account holder but actually knows that an account holder is a U.S. non-exempt recipient, QI shall disclose to the withholding agent any information QI has in its possession regarding the name, address, and taxpayer identification number of such person. The Form W-9 (or name, address, and taxpayer identification number) of the U.S. non-exempt recipient must be sent to the withholding agent with instructions to associate it with the appropriate account for which QI is acting as a qualified intermediary. QI need not disclose to the withholding agent any other account holder documentation.

## SECTION 7. DETERMINATION OF ASSET CATEGORIES AND CLASSES FOR QI'S WITHHOLDING CERTIFICATE

**Sec. 7.01. Statement of Asset Classes.** QI shall furnish to the withholding agent a written statement described in this section 7. The statement forms an integral part of the Form W-8IMY. The statement shall separate those assets that generate, or could generate, reportable amounts into the three overall categories described in section 7.02 of this Agreement and into the classes of assets described in section 7.03 of this Agreement. The written statement may be provided in any form and in any manner the QI and withholding agent choose. QI shall use the documentation obtained under section 5 of this Agreement, or the presumption rules under section 5.13 of this Agreement, as the basis for determining categories and classes of assets. QI shall update the statement as often as necessary so that the withholding agent has the information necessary to satisfy its reporting and withholding obligations. All such updates form an integral part of QI's Form W-8IMY.

**Sec. 7.02. Categories of Assets. QI must separate assets into the following three overall categories of assets:**

**(A)** Assets associated with documented foreign account holders;

**(B)** Assets associated with documented U.S. account holders; and

**(C)** Assets associated with undocumented account holders.

**Sec. 7.03. Class of Assets.** A class of assets is a group of assets within a category of assets that produces the same type of income, is subject to the same rate of withholding, and is associated with the same type of account holders as specified in paragraphs (A) through (G) of this section 7.03. A type of income is any item of income subject to the same income code and, unless the income is allocable to U.S. account holders, the same exemption code on Form 1042-S. Notwithstanding the preceding two sentences, assets that generate a specific type of income and that are allocable to each U.S. non-exempt recipient are a separate class of assets, unless QI assumes Form 1099 reporting and backup withholding responsibility for reportable payments allocable to U.S. non-exempt recipient account holders. If QI has an account holder that is another intermediary (whether a qualified intermediary, a nonqualified intermediary, or a private arrangement intermediary) or a foreign partnership (whether or not a withholding foreign partnership), QI shall combine the asset information provided by the intermediary or partnership to QI's own classes of assets. Thus, QI shall identify classes of assets as follows:

**(A)** Assets that are associated with documented foreign account holders and that generate a specific type of income (as determined by reference to the income and exemption codes on Form 1042-S) subject to a single withholding rate. If QI assumes primary withholding responsibility for assets in an account, the income from those assets is considered subject to a zero rate of withholding;

**(B)** Assets that are associated with all documented U.S. exempt recipient account holders and that generate a specific type of income (as determined by reference to the income, but not exemption, codes on Form 1042-S);

**(C)** Assets that are associated with each documented U.S. non-exempt recipient account holder for which QI does not assume Form 1099 reporting and backup withholding responsibility. In addition, for any U.S. non-exempt recipient account holder that receives a reportable amount from a withholding agent, QI shall inform the withholding agent of the assets associated with such U.S. non-exempt recipient account holder that generate, or could generate, reportable payments that are not included in reportable amounts (e.g., broker proceeds, foreign source interest, or foreign source dividends);

**(D)** Assets that are associated with all documented U.S. non-exempt recipient account holders for which QI does assume Form 1099 reporting and backup withholding responsibility and that generate a specific type of income (as determined by reference to the income, but not exemption, codes on Form 1042-S);

**(E)** Assets that are associated with each undocumented account holder that QI actually knows is a U.S. non-exempt recipient;

**(F)** Assets that are associated with undocumented account holders that generate reportable amounts (other than U.S. source bank deposit interest or interest and OID on short-term obligations) that a withholding agent must presume is paid to an undocumented payee that is a foreign person (30 percent withholding applies); and

**(G)** Assets that are associated with undocumented account holders that generate bank deposit interest or interest and OID on short-term obligations that a withholding agent must presume are made to a payee that is a U.S. non-exempt recipient (31percent backup withholding applies).

## SECTION 8. WITHHOLDING OBLIGATIONS

**Sec. 8.01. Primary Withholding Responsibility Under Chapter 3 Not Assumed.** QI shall withhold the difference between the amount of tax required to be withheld under chapter 3 of the Code and the amount actually withheld by any other withholding agent to the extent that QI knows, or has reason to know, that the appropriate amount has not been withheld. In addition, if QI has insufficient information to allocate the reportable amounts (other than bank deposit interest and short-term interest or OID) to each of a nonqualified intermediary's account holders (or partners of a foreign partnership that is not a withholding foreign partnership) then QI must withhold the difference between 30 percent of the amount paid to those account holders (or partners) for whom QI does not hold allocation information and the amount, if any, actually withheld by the withholding agent. Notwithstanding the preceding sentence, QI shall not have any liability for tax under section 1461 of the Code if QI obtains the allocation information by the time that QI is required to file Forms 1042 and 1042-S for the calendar year. The amounts so withheld shall be deposited in accordance with section 8.05 of this Agreement and shall be reported on Forms 1042 and 1042-S in accordance with sections 9 and 10 of this Agreement. QI is not required, however, to withhold on amounts it pays to another qualified intermediary or withholding foreign partnership that has certified to QI on Form W-8IMY that it has assumed primary withholding responsibility.

**Sec. 8.02. Primary Withholding Responsibility Under Chapter 3 Assumed.** To the extent that QI has assumed primary withholding responsibility for reportable amounts it receives from a withholding agent, QI shall withhold the amount of tax required to be withheld under chapter 3 of the Code. The amounts withheld shall be deposited in accordance with section 8.05 of this Agreement and shall be reported on Forms 1042 and 1042-S in accordance with sections 9 and 10 of this Agreement. QI is not required, however, to withhold on amounts it pays to another qualified intermediary or withholding foreign partnership that has certified to QI on Form W-8IMY that it has assumed primary withholding responsibility.

**Sec. 8.03. Backup Withholding Responsibility Not Assumed.** Notwithstanding its ineligibility to assume backup withholding or its election not to assume backup withholding, QI shall withhold under section 3406 on any reportable payments that it pays to an account holder only if it has actual knowledge that the account holder is a U.S. non-exempt recipient on whose behalf QI has received a reportable amount and QI cannot reliably associate the reportable payment with a valid Form W-9 and another payor has not withheld under chapter 3 or section 3406 of the Code. That is, in accordance with Treas. Reg. §31.3406(g)-1(e), QI shall not be required to withhold under section 3406 on a reportable payment that QI makes outside the United States to an offshore account (or, in the case of broker proceeds, effects a sale outside the United States) unless QI has actual knowledge that the account holder is a United States non-exempt recipient who has not provided a valid Form W-9. An offshore account means an account maintained at an office or branch of QI at any location outside the United States and outside possessions of the United States. Whether a payment is made outside the United States is determined under the rules of Treas. Reg. §1.6049-5(e). QI is not required to withhold under section 3406 on any reportable payment that was subject to 30 percent withholding under chapter 3 of the Code by another payor. The amounts withheld shall be deposited in accordance with section 8.05 of this Agreement and shall be reported on Forms 945 and 1099 filed in accordance with sections 9 and 10 of this Agreement. QI is not required, however, to withhold on amounts it pays to another qualified intermediary if that other qualified intermediary has certified to QI on Form W-8IMY that it has assumed primary backup withholding responsibility.

**Sec. 8.04. Backup Withholding Responsibility Assumed.** To the extent that QI has assumed Form 1099 reporting and backup withholding responsibility for reportable payments it receives from a withholding agent, QI shall report and withhold in accordance with chapter 61 and section 3406 of the Code. Notwithstanding the preceding sentence, the exceptions to Form 1099 reporting under chapter 61 that apply to a foreign source amount paid outside the United States by a non-U.S. payor or non-U.S. middleman shall not apply to QI to the extent those amounts are received from an account for which QI is acting as a qualified intermediary. In addition, the exception from backup withholding under Treas. Reg. §31.3406(g)-1(e) shall not apply. That is, QI must backup withhold on amounts it actually knows, or must presume, to be paid to a U.S. non-exempt recipient. The amounts withheld shall be deposited in accordance with section 8.05 of this Agreement and shall be reported on Forms 945 and 1099 filed in accordance with sections 9 and 10 of this Agreement. QI is not required, however, to withhold on amounts it pays to another qualified intermediary if that other qualified intermediary has certified to QI on Form W-8IMY that it has assumed primary backup withholding responsibility.

**Sec. 8.05. Deposit Requirements.** QI must deposit amounts withheld under sections 1441, 1442, 1443, or 3406 of the Code with a Federal Reserve bank or authorized financial institution as provided in Treas. Reg. §1.6302-2(a) or §31.6302-1.

## SECTION 9. TAX RETURN OBLIGATIONS

**Sec. 9.01. Form 1042 Filing Requirement. (A) In general.** QI shall file a return on Form 1042 on or before March 15 of the year following the calendar year in which QI acts as a qualified intermediary. Form 1042 shall be filed with the Internal Revenue Service Center, Philadelphia, PA 19255. In addition to the information specifically requested on Form 1042 and the accompanying instructions, QI shall attach to the form the following information:

**(i)** A schedule setting forth the reportable amounts that QI received in its capacity as a qualified intermediary during the calendar year, and the name, address, and employer identification number of each withholding agent from whom the reportable amounts were received; and

**(ii)** A statement setting forth the amounts of any overwithholding (overpayment) or underwithholding (balance due) adjustments made under Treas. Reg. §1.1461-2 and sections 11.02 and 11.05 of this Agreement, and an explanation of the circumstances that resulted in the over- or under- withholding.

**(B) Extensions For Filing Returns.** QI may request an extension of the time for filing Form 1042, or any of the information required to be attached to the form, by submitting Form 2758, Application for Extension of Time to File Certain Excise, Income, Information, and Other Returns on or before the due date of the return. The application must be in writing, properly signed by a duly authorized agent of QI, and shall clearly set forth the following:

(i) The calendar year for which the extension is requested;

(ii) Whether the extension request is for the return, information required to be attached to the return, or both; and

(iii) A full explanation of the reasons for requesting the extension to assist the IRS in determining the period of extension, if any, that will be granted.

**Sec. 9.02. Form 945 Filing Requirement.** QI shall file a return on Form 945 on or before January 31 following the calendar year in which QI withholds any amount under section 3406 of the Code. The form must be filed at the address specified in the instructions for Form 945.

**Sec. 9.03. Retention of Returns.** QI shall retain Forms 945 and 1042 for the applicable statute of limitations on assessments and collection for the amount reported on the form.

## SECTION 10. INFORMATION REPORTING OBLIGATIONS

**Sec. 10.01. Form 1042-S Reporting.** Except as otherwise provided in section 10.02 of this Agreement, QI is not required to file Forms 1042-S for amounts paid to each beneficial owner account holder or payee for whom such reporting would otherwise be required. In place of such Forms 1042-S, QI shall file a Form 1042-S reporting the income from classes of assets as determined in sections 10.03 and 10.04 of this Agreement. QI must file its Forms 1042-S in the same manner as required by the instructions to the form. Any Form 1042-S required by this section 10 shall be filed on or before March 15 following the calendar year in which the payment reported on the form was made. QI may request an extension of time to file Forms 1042-S by submitting Form 8809, Request for Extension of Time to File Information Returns, by the due date of Forms 1042-S in the manner required by Form 8809.

**Sec. 10.02. Beneficial Owner Reporting.** QI is required to file Forms 1042-S for amounts paid to each beneficial owner account holder or other payee as described in this section 10.02.

**(A)** QI must file Forms 1042-S, by income type, exemption code, and withholding rate, for each qualified intermediary or withholding foreign partnership from whom it receives a Form W-8IMY;

**(B)** QI must file a Form 1042-S for each of the account holders of a nonqualified intermediary (other than the account holders of a PAI) or foreign partnership (other than a withholding foreign partnership) for which the nonqualified intermediary or foreign partnership has provided documentation and allocation information sufficient to determine the amount of income paid to such account holder of the nonqualified intermediary or foreign partnership;

**(C)** QI must file a Form 1042-S made out to an unknown person for income paid to account holders of a nonqualified intermediary or foreign partnership (other than a withholding foreign partnership) that are undocumented and presumed to be foreign persons;

**(D)** QI must file a Form 1042-S made out to an unknown person for income paid to documented foreign account holders of the nonqualified intermediary or foreign partnership (other than a withholding foreign partnership) for which QI does not have allocation information sufficient to determine the amount of income paid to such account holders; and

**(E)** Upon request by the IRS, QI must provide, in the manner requested, the names, addresses, taxpayer identification number, if any, and the amounts paid to those account holders who receive annually $100,000 or more of income for which the account holder claimed a reduced rate of withholding under an income tax treaty and who certify in accordance with section 5.04 of this Agreement that they meet the Limitation on Benefits provision of an income tax treaty and that they derive the income within the meaning of Treas. Reg. §1.894-1T(d). The $100,000 threshold is determined by aggregating all the accounts of an account holder. The threshold shall be determined separately for QI and for each of the affiliated entities of QI described in Appendix A; however, accounts of an account holder at all the branches of any one entity must be aggregated. Notwithstanding the preceding sentence, accounts of an account holder with QI and affiliates of QI must be aggregated if QI, or any of its affiliates, knows, or has reason to know, that the account holder is attempting to avoid disclosure by opening separate accounts. Further, QI, and any of its affiliated entities, must aggregate the accounts of an account holder, and any persons having the relationship described in section 267(b) of the Code with the account holder if QI, or any of its affiliates, actually know that the account holder is attempting to avoid disclosure by having such persons open accounts in their names.

**Sec. 10.03. Categories of Assets For Form 1042-S Reporting.** For purposes of determining amounts to be reported on Form 1042-S, QI shall determine classes of assets by first dividing all of the assets for which it acts as a qualified intermediary into the three overall categories described in this section 10.03 and then dividing each of those categories into classes of assets as described in section 10.04 of this Agreement. Income from each class of assets shall be reported on a separate Form 1042-S. QI must separate its assets into the following 3 overall categories:

**(A)** Assets associated with documented foreign account holders;

**(B)** Assets associated with documented U.S. account holders; and

**(C)** Assets associated with undocumented account holders.

**Sec. 10.04. Classes of Assets for Form 1042-S Reporting.** A class of assets is a group of assets within a category of assets that produces the same type of income, is subject to the same rate of withholding, and is associated with the same type of account holders located in the same country. A type of income is determined by reference to the income and exemption codes on Form 1042-S. A type of account holder is determined by reference to the recipient codes to be used solely by a qualified intermediary on Form 1042-S. Thus, QI shall report on a separate Form 1042-S income from each of the following classes of assets:

**(A)** Assets that are associated with documented foreign beneficial owners that are the same type of account holder, are located in the same foreign country, receive the same type of income, and are subject to the same rate of withholding;

**(B)** Assets associated with all documented U.S. exempt recipients who receive the same type of income;

**(C)** Assets that are associated with all undocumented account holders that generate reportable amounts (other than U.S. source bank deposit interest or U.S. source interest and OID on short-term obligations); and

**(D)** Assets associated with a PAI whose account holders are of the same type, located in the same foreign country, receive the same type of income, and are subject to the same rate of withholding.

**Sec. 10.05. Form 1099 Reporting Responsibility.** QI shall file Forms 1099 and, unless filing magnetically, Form 1096, for reportable payments paid to the persons specified in this section 10.05. Forms 1099 shall be filed on or before the date prescribed for the particular Form 1099 under chapter 61 of the Code. Extensions on the time to file Forms 1099 may be requested by submitting Form 8809, Request for Extension of Time to File Information Returns, in the manner required by the form.

**(A)** QI must file a Form 1099 for each U.S. non-exempt recipient receiving payments for which QI has assumed Form 1099 reporting responsibility;

**(B)** If QI assumes Form 1099 reporting and backup withholding responsibility, QI must file a Form 1099 made out to an unknown person for income that is paid to a nonqualified intermediary or foreign partnership that QI must presume is made to a nonexempt recipient (e.g., short-term OID or bank deposit interest for which QI does not hold Forms W-8, W-9 or documentary evidence or reportable payments (other than reportable amounts) for which a nonqualified intermediary or foreign partnership has failed to provide allocation information;

**(C)** QI must file a Form 1099 for each U.S. non-exempt recipient for whom QI has failed to provide a Form W-9 in its possession to a withholding agent or failed to provide sufficient information to the withholding agent for the withholding agent to report the amount on Form 1099;

**(C)** QI must file a Form 1099 for each person QI actually knows to be a U.S. non-exempt recipient who has not provided QI with a Form W-9 if QI has not given that person's name, address, taxpayer identification number, if any, and asset allocation information to another payor; and

**(D)** QI must file a Form 1099 for each person to whom QI has made a payment on which QI withheld an amount under section 3406 of the Code.

## SECTION 11. ADJUSTMENTS FOR OVER- AND UNDER-WITHHOLDING; REFUNDS

**Sec. 11.01. Adjustments for Overwithholding by Withholding Agent.** QI may request a withholding agent to make an adjustment for amounts paid to QI on which the withholding agent has overwithheld under chapter 3 of the Code by applying either the reimbursement or set-off procedures described in this section within the time period prescribed for those procedures.

**(A) Reimbursement Procedure.** QI may request a withholding agent to repay QI for any amount overwithheld under chapter 3 of the Code and for the withholding agent to reimburse itself under the reimbursement procedures of Treas. Reg. §1.1461-2(a)(2)(i) by making the request to the withholding agent prior to the due date for filing the Form 1042 and Form 1042-S (without regard to extensions) for the calendar year of overwithholding. Nothing in this section shall be interpreted to require a withholding agent to reimburse QI under Treas. Reg. §1.1461–2(a)(2)(i).

**(B) Set-off Procedure.** QI may request a withholding agent to repay QI by applying the amount overwithheld against any amount which otherwise would be required under chapter 3 of the Code to be withheld from income paid by the withholding agent to QI. QI must make the request before the earlier of the due date (without regard to extensions) for the withholding agent to file Form 1042-S for the calendar year of overwithholding or the date that the Form 1042-S is actually filed with the IRS.

**Sec. 11.02. Adjustments for Chapter 3 Overwithholding by QI.** QI may make an adjustment for amounts paid to its account holders that it has overwithheld under chapter 3 of the Code by applying either the reimbursement or set-off procedures described in this section within the time period prescribed for those procedures.

**(A) Reimbursement Procedure.** QI may repay its account holder for an amount overwithheld and reimburse itself by reducing, by the amount of tax actually repaid to the beneficial owner or payee, the amount of any deposit of tax made by the withholding agent under section 6302 of the Code and Treas. Reg. §1.6302–2(a)(1)(iii) for any subsequent payment period occurring before the end of the calendar year following the calendar year of overwithholding. Any such reduction that occurs for a payment period in the calendar year following the calendar year of overwithholding shall be allowed only if:

(i) QI states on a timely filed (not including extensions) Form 1042-S for the calendar year of withholding issued to the recipient of the income or, if appropriate, the Form 1042-S reporting income from a class of assets as described in section 10.04 of this Agreement, the amount of tax withheld and the amount of any actual repayments; and

(ii) QI states on a timely filed (not including extensions) Form 1042 for the calendar year of overwithholding, that the filing of the Form 1042 constitutes a claim for credit in accordance with Treas. Reg. §1.6414–1.

**(B) Set-Off Procedure.** QI may repay its account holder by applying the amount overwithheld against any amount which otherwise would be required under chapter 3 of the Code or the regulations thereunder to be withheld from income paid by QI to the account holder before the earlier of the due date (without regard to extensions) for filing the Form 1042-S for the account holder or the withholding pool, as appropriate, for the calendar year of overwithholding or the date that the Form 1042-S is actually filed with the IRS. For purposes of making a return on Form 1042 or 1042-S (or an amended form) for the calendar year of overwithholding, and for purposes of making a deposit of the amount withheld, the reduced amount shall be considered the amount required to be withheld from such income under chapter 3 of the Code.

**Sec. 11.03. Repayment of Backup Withholding.** If QI erroneously withholds, as defined under Treas. Reg. §31.6413(a)-3, an amount under section 3406 of the Code from a payee, QI may refund the amount erroneously withheld as provided in Treas. Reg. §31.6413(a)–3.

**Sec. 11.04. Collective Refund or Credit Procedures for Chapter 3 Overwithholding.** If there has been overwithholding under chapter 3 of the Code on the total amount of reportable payments paid to QI's account holders during a calendar year and the amount has not been recovered under the reimbursement or set-off procedures under sections 11.02 or 11.03 of this Agreement, QI may request a refund or credit of the total amount overwithheld for account holders for whom QI acts as a qualified intermediary by following the procedures of this section 11.04. QI shall not include in its collective refund claim payments made to another qualified intermediary, a withholding foreign partnership, a nonqualified intermediary, or the account holders of a nonqualified intermediary. QI shall follow the procedures set forth under sections 6402 and 6414 of the Code, and the regulations thereunder, to claim the credit or refund. No credit or refund will be allowed after the expiration of the statutory period of limitation for refunds under section 6511 of the Code. QI may use the collective refund procedures under this section 11.04 only if the following conditions are met:

**(A)** QI must not have issued a Form 1042-S to the account holders from whose payment the amount has been overwithheld;

(B) QI must submit together with its amended return on which it claims a credit or refund a statement that QI has repaid the tax to the account holder prior to filing the claim for refund or credit; and

**(C)** QI must retain a record that it paid, or credited the account of, the account holder the amount of the overwithholding.

**Sec. 11.05. Adjustments for Chapter 3 Underwithholding.** If QI knows that an amount should have been withheld under chapter 3 of the Code from a previous payment to an account holder but was not withheld, QI may either withhold from future payments made to the same account holder or satisfy the tax from property that it holds in custody for the account holder or property over which it has control. The additional withholding or satisfaction of the tax owed may only be made before the due date of the Form 1042 (not including extensions) for the calendar year in which the underwithholding occurred.

**Sec. 11.06. Underwithholding After Form 1042 Filed.** If, after a Form 1042 has been filed for a calendar year, QI, the external auditor designated in Appendix B of this Agreement, or the IRS determines that QI has underwithheld tax for such year, QI shall file an amended Form 1042 to report and pay the underwithheld tax for such year. QI shall pay the underwithheld tax, the interest due on the underwithheld tax, and any applicable penalties, at the time of filing the amended Form 1042. If QI fails to file an amended return, the IRS shall make such return under section 6020 of the Code.

**SECTION 12. EXTERNAL AUDIT PROCEDURES.**

**Sec. 12.01. In General.** The IRS shall not conduct an on-site audit of QI, or any PAI with which QI has an agreement, provided that the external auditor designated in Appendix B of this Agreement conducts an audit of QI, and any PAI, in accordance with this section 12. QI shall permit the external auditor to have access to all relevant records of QI for purposes of performing the external audit. QI shall permit the IRS to communicate directly with the external auditor in regard to the audit and to review the audit procedures followed by the external auditor. QI shall permit the IRS to examine the external auditor's work papers and reports prepared by the external auditor. However, the external auditor is not required to divulge the identity of QI's account holders to the IRS.

**Sec. 12.02. Designation of External Auditor.** QI's external auditor must be approved by the IRS before this Agreement is executed. The IRS and QI agree that the auditor designated in Appendix B of this Agreement shall be the external auditor, unless QI and the IRS agree to substitute another auditor. QI shall not propose an external auditor to the IRS unless the auditor is subject to regulatory supervision under the laws of the country, or countries, designated in Appendix A of this Agreement.

**Sec. 12.03. Timing and Scope of External Audits.** QI shall have the external auditor conduct an audit of the second calendar year and the fifth calendar year that this Agreement is in effect, subject to section 12.05 of this Agreement. The external auditor shall verify whether QI is in compliance with this Agreement by conducting an audit that meets the requirements of this section 12.03. The external auditor shall verify whether QI has complied with its obligations under all provisions of sections 4 through 11 of this Agreement by:

**(A)** Verifying that QI has in place adequate procedures to comply with QI's obligations under sections 5 through 11 of this Agreement;

**(B)** Interviewing employees responsible for complying with QI's obligations under sections 5 through 11 of this Agreement to determine if they are knowledgeable and adequately trained with regard to such obligations; and

**(C)** Reviewing account holder information using valid sampling techniques (including, if appropriate, a statistical sampling) to determine if QI has complied with its obligations under sections 5, 6, 7, 8, 10, and 11 of this Agreement; and

**(D)** With respect to QI's obligations under sections 9, 10, and 11, obtaining copies of original and amended Forms 1042, 945, 1042-S, 1096, and 1099, and any schedules or statements required to be filed with those returns, and reviewing those forms for accuracy.

**(E)** Reviewing QI's agreements with PAIs, if any, to verify that PAI has agreed to perform all of the obligations of QI under this Agreement, except as provided in section 4.02 of this Agreement.

**Sec. 12.04. External Auditor's Report.** Upon completion of the audit of QI and any PAI, the external auditor shall issue a report, or reports, of audit findings directly to the IRS by sending the original report to the IRS at the address set forth in section 14.06 of this Agreement by June 30 following the calendar year being audited, or if that date falls on a Saturday or Sunday, the next U.S. business day. The report must be in writing, in English, and currency amounts must be stated in U.S. dollars. The report must fully describe the scope of the audit, the methodologies (including sampling techniques) used to determine whether QI is in compliance with each provision of section 5 through 11 of this Agreement, and the result of each such determination.

**Sec. 12.05. Expanding Scope and Timing of External Audit.** Upon review of the external auditor's report, the IRS may request, and QI must permit, the external auditor to perform additional audit procedures, or to expand the external audit to cover some or all of the calendar years for which the period of limitations for assessment of taxes has not expired. In addition, the IRS may request, and QI must permit, that the external auditor perform an audit for one or more calendar years not scheduled for audit pursuant to section 12.03 of this Agreement.

## SECTION 13. EXPIRATION, TERMINATION AND DEFAULT

**Sec. 13.01. Term of Agreement.** This Agreement shall be in effect on January 1 of the calendar year following the year in which this agreement is executed and shall expire on December 31, of the sixth calendar year for which this Agreement is in effect. This Agreement may be renewed as provided in section 13.06 of this Agreement.

**Sec. 13.02. Termination of Agreement.** This Agreement may be terminated by either the IRS or QI prior to the end of its term by delivery of a notice to the other party in accordance with section 14.06 of this Agreement. The IRS, however, shall not terminate the Agreement unless there has been a significant change in circumstances, as defined in section 13.03 of this Agreement, or an event of default has occurred, as defined in section 13.04 of this Agreement, and the IRS determines, in its sole discretion, that the significant change of circumstances or the event of default warrants termination of this Agreement. In addition, the IRS shall not terminate this Agreement in the event of default if QI can establish to the satisfaction of the IRS that all events of default for which it has received notice have been cured within the time period agreed upon. The IRS shall notify QI, in writing, that an event of default has occurred and that the IRS intends to terminate the Agreement unless QI cures the default in accordance with section 13.05 of this Agreement. A notice of termination sent by either party shall take effect on the date specified in the notice.

**Sec. 13.03. Significant Change in Circumstances.** For purposes of this Agreement, a significant change in circumstances means:

**(A)** An acquisition of all, or substantially all, of QI's assets in any transaction in which QI is not the surviving legal entity;

**(B)** A change in U.S. federal law that affects the validity of, or materially affects, the procedures contained in this Agreement;

**(C)** A ruling of any court that affects the validity of any provision of this Agreement;

**(D)** A change in the laws and procedures set forth in any Attachment to this Agreement; or

**(E)** A significant change in QI's business practices that affects QI's ability to meet its obligations under this Agreement.

**Sec. 13.04. Events of Default.** For purposes of this Agreement, an event of default occurs if QI fails to perform any material duty or obligation required under this Agreement, and includes, but is not limited to, the occurrence of any of the following:

**(A)** QI fails to implement adequate procedures, accounting systems, and internal controls to ensure compliance with this Agreement;

**(B)** QI underwithholds the amount required to be withheld under chapter 3 of the Code and fails to correct the underwithholding or file an amended Form 1042 reporting, and paying, the appropriate tax under sections 11.05 and 11.06 of this Agreement;

**(C)** QI underwithholds the amount required to be withheld under section 3406 of the Code;

**(D)** QI makes a misrepresentation on Forms W-8IMY or attaches to the form information regarding classes of assets that results in underwithholding by the withholding agent;

**(E)** QI makes excessive refund claims;

**(F)** QI knows or has reason to know that the documentation required under section 5 of this Agreement is lacking, incorrect, or unreliable for a significant number of account holders;

**(G)** QI fails to timely file Forms 945, 1042, 1042-S, or 1099 or files forms that are materially incorrect or fraudulent;

**(H)** QI fails to have an external audit performed when required, fails provide an external auditor's report directly to the IRS on a timely basis, or QI or its external auditor fails to cooperate with the IRS;

**(I)** QI fails to disclose to a withholding agent or to the IRS those account holders required to be disclosed under sections 6 and 10 of this Agreement;

**(J)** QI fails to inform the IRS of any change in the laws and procedures described in any Attachment to this Agreement within 90 days of the change becoming effective;

**(K)** QI fails to inform the IRS within 90 days of any significant change in its business practices to the extent that change affects QI's obligations under this Agreement;

**(L)** QI fails to inform the IRS of any private arrangement, as described in section 4 of this Agreement;

**(M)** QI fails to cure a defect identified in an external audit report;

**(N)** QI makes any fraudulent statement or a misrepresentation of material fact with regard to this Agreement to the IRS, a withholding agent, or its external auditor;

**(O)** The IRS determines that the external auditor is not sufficiently independent to adequately perform its audit function; or

**(P)** An intermediary with which QI has a PAI agreement is in default with that agreement and QI fails to meet its obligation to terminate that agreement within the time period specified in section 4.03 of this Agreement.

**Sec. 13.05. Notice and Cure.** Upon the occurrence of an event of default, the IRS may deliver to QI a notice of default specifying the event of default that has occurred. QI shall respond to the notice of default within 60 days from the date of the notice. The response shall contain an offer to cure the event of default, and the time period in which the cure will be accomplished, or shall state the reasons why QI does not agree that an event of default has occurred. If QI does not respond within 60 days of the notice of default, the IRS may deliver a notice of termination as provided in section 13.02 of this Agreement. The IRS shall respond to QI's response, by either accepting or rejecting the offer of cure, or by setting forth a counter-proposal for cure of the event of default. If QI has stated that it does not agree that an event of default has occurred, or if the IRS rejects an offer of cure by QI and QI does not accept the IRS's counterproposal within 30 days of receiving that counterproposal, the parties shall seek to resolve their disagreement within 30 days of the IRS's receipt of QI's response. At the end of this latter 30-day period, or, to the extent QI failed to reply to the IRS's rejection or counter-proposal within 30 days, at the end of the earlier 30 day period, the IRS may terminate this Agreement in accordance with section 13.02 of this Agreement. If QI receives a notice of termination from the IRS, it may appeal the determination to terminate this Agreement by sending a written notice to the Director, International District, OP:IN:D, 950, L'Enfant Plaza South, SW, Washington DC, 20024.

**Sec. 13.06. Renewal.** If QI intends to renew this Agreement, it shall submit an application for renewal to the IRS no earlier than one year and no later than six months prior to the expiration of this Agreement. Any such application for renewal must contain an update of the information provided by QI to the IRS in connection with the application to enter into this Agreement, and any other information the IRS may request in connection with the renewal process. This Agreement shall be renewed only upon the signatures of both QI and the IRS. Either the IRS or QI may seek to negotiate a new qualified intermediary agreement rather than renew this Agreement.

**SECTION 14. MISCELLANEOUS PROVISIONS.**

**Sec. 14.01.** QI's application to become a qualified intermediary and all the Appendices and Attachments to this Agreement are hereby incorporated into and made an integral part of this Agreement. This Agreement, QI's application, and the Appendices and Attachments to this Agreement constitute the complete agreement between the parties.

**Sec. 14.02.** This Agreement may not be amended, modified, or superceded other than by written agreement of QI and the IRS.

**Sec. 14.03.** Any waiver of a provision of this Agreement is a waiver solely of that provision. The waiver does not obligate the IRS to waive other provisions of this Agreement or the same provision at a later date.

**Sec. 14.04.** This Agreement shall be governed by the laws of the United States. Any legal action brought under this Agreement shall be brought only in a United States court with jurisdiction to hear and resolve matters under the internal revenue laws of the United States.

**Sec. 14.05.** QI's rights and responsibilities under this Agreement can not be assigned to another person.

**Sec. 14.06.** Notices provided under this Agreement shall be directed as follows:

To the IRS

Office of the Assistant Commissioner (International)
Foreign Payments Branch
OP:IN:D:WT
950 L'Enfant Plaza South, SW
Washington D.C. 20024

To QI:

________________________________

________________________________

________________________________

________________________________

Notices shall be mailed registered, first class air mail.

**Sec. 14.08.** QI, acting in its capacity as a qualified intermediary or any other capacity, does not act as an agent of the IRS, nor does it have the authority to hold itself out as an agent of the IRS.

**IN WITNESS WHEREOF,** the above parties have subscribed their names to these presents, in triplicate.

**Signed this day of , 1998**

________________________________
**(name and title of person signing for QI)**

**Internal Revenue Service**

**By________________________________**
**Assistant Commissioner (International)**

## Appendix A

[Name of QI]

[Name of country] (see Attachment 1, for description of know-your customer rules).

[Name of country] (see Attachment 2, for description of know-your customer rules).

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[Name of entity affiliated with QI]

[Name of country] (see Attachment ____, for description of know-your customer rules).

[Name of country] (see Attachment ____, for description of know-your customer rules).

## ATTACHMENT[4]

1. QI is subject to the following laws and regulations of [name of country] governing the requirements of QI to obtain documentation confirming the identity of QI's account holders.
2. QI represents that [name and citations to laws and regulations identified in item 1, above] are enforced by [name of enforcement body] and QI shall provide the IRS with an English translation of any reports or other documentation issued by [name of enforcement body] that relates to QI's compliance with [laws and regulations identified in 1, above].
3. QI represents that the following penalties apply for failure to obtain, maintain, and evaluate documentation obtained under [name and citations to laws and regulations identified in item 1].
4. QI shall use the following documentary evidence to comply with section 5.03 of this Agreement:

   a. For natural persons:

   b. For legal persons:
5. QI shall follow the procedures set forth below to establish a person's permanent residency address.
6. QI shall follow the procedures set forth below to confirm the identity of account holders that do not open accounts in person.
7. QI represents that it will follow the procedures set forth below to determine whether an account holder is acting as an intermediary, and, if it is, to identify the beneficial owners for whom the intermediary is acting.
8. QI shall follow the procedures set forth below to obtain new documentation, or renew existing documentation, in accordance with [name and citations to laws and regulations identified in item 1].

8. QI shall retain the documentary evidence obtained under [name and citations to laws and regulations identified in item 1] for the following period.

Section 3. Contact Information

The principal authors of this notice are Kate Y. Hwa and Laurie Hatten-Boyd of the Office of the Associate Chief Counsel (International). For further information regarding Section I of this notice, contact Ms. Hwa at 202-622-3840 (not a toll-free number). For further information regarding Section II of this notice, contact Ms. Hatten-Boyd at (202) 622-3840 (not a toll-free call) or Tom Logan at 202-874-1800 (not a toll-free number).

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[4] A separate attachment will be created for each country in which QI, or an entity affiliated with QI, operates.

*26 CFR 601.202: Closing agreements.*

## Rev. Proc. 99–13

### SECTION 1. PURPOSE AND OVERVIEW

.01 *Application of EPCRS to 403(b) Plans.* This revenue procedure provides a comprehensive system of correction programs and procedures for an employer that offers a plan that is intended to satisfy the requirements of § 403(b) of the Internal Revenue Code (the "Code"), but that has failed to satisfy those requirements because of Operational, Demographic, or Eligibility Failures. This system permits an employer to correct these failures, and thereby provide its employees with retirement benefits on a tax-favored basis. This revenue procedure modifies and amplifies the Employee Plans Compliance Resolution System (EPCRS), set forth in Rev. Proc. 98–22, 1998–12 I.R.B. 11, to include specific programs and procedures relating to 403(b) Plans. In addition, this revenue procedure replaces the program described in Rev. Proc. 95–24, 1995–1 C.B. 694, which established the Tax Sheltered Annuity Voluntary Correction (TVC) program, and which was extended by Rev. Proc. 96–50, 1996–2 C.B. 370. Except as otherwise indicated in this revenue procedure, the specific provisions of EPCRS apply to 403(b) Plans.

.02 *Overview of EPCRS.* Pursuant to Rev. Proc. 98–22, as modified by this revenue procedure, the following programs comprise EPCRS for correction of failures with respect to a 403(b) Plan.

(1) APRSC: Self-correction. The Administrative Policy Regarding Self-Correction (APRSC), as described in Rev. Proc. 98–22, is a voluntary employer-initiated program that does not involve Service approval. Under APRSC, an employer that has compliance practices and procedures may correct Operational Failures, without paying any fee or sanction, including Operational Failures relating to contributions to a 403(b) Plan that are in excess of the § 415 limit or the § 403(b)(2) limit (the exclusion allowance). APRSC is described in Section 7 of Rev. Proc. 98–22, as modified by sections 4 and 5 below.

(2) TVC: Voluntary correction with Service approval. Under TVC, an employer or plan that is not Under Examination (as defined in Section 5.06 of Rev. Proc. 98–22) may pay a limited fee and receive the Service's approval for the correction in the form of a closing agreement with the appropriate Key District Office. TVC allows correction of Operational Failures, Demographic Failures, and Eligibility Failures that are within the jurisdiction of the EP/EO Division of the Key District Office, including a Plan of an Ineligible Employer. TVC is described in sections 4, 6, 7, and 8 below.

(3) Audit CAP for 403(b) Plans: Correction on audit. Audit CAP as described in Rev. Proc. 98–22 is expanded by this revenue procedure to cover closing agreements in connection with a 403(b) Plan that is Under Examination. Under Audit CAP for 403(b) Plans, if an Operational Failure that is not eligible for APRSC, a Demographic Failure, or an Eligibility Failure is identified with respect to a 403(b) Plan that is Under Examination, and the failure is corrected, the sanction imposed will bear a reasonable relationship to the nature, extent, and severity of the failure. Audit CAP for 403(b) Plans is described in section 9 below (extending the program described in Sections 14 and 15 of Rev. Proc. 98–22).

.03 *Request for comments.* The Service specifically solicits comments or suggestions relating to the guidance provided in this revenue procedure. It is requested that comments or suggestions be submitted by May 2, 1999, addressed to CC:DOM:CORP:R (Rev. Proc. 99–13), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Rev. Proc. 99–13), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically via the Service's Internet site at "http://www.irs.ustreas.gov/prod/tax_regs/comments.html".

### SECTION 2. EFFECT OF EPCRS; RELIANCE

.01 *Income taxes.* If the applicable eligibility requirements are satisfied and the employer corrects a failure in accordance with the requirements of APRSC, TVC, or Audit CAP for 403(b) Plans, the Service will not pursue income inclusion for affected participants, or liability for income tax withholding, on account of the failure. However, the correction of a failure may itself result in income tax consequences to participants (for example, participants may be required to include in gross income distributions of Excess Amounts in the year of distribution).

.02 *Excise and employment taxes.* Excise taxes, FICA taxes, and FUTA taxes (and corresponding withholding obligations), if applicable, that result from a failure are not waived merely because the failure has been corrected.

.03 *Other taxes and penalties.* See Section 6.04 of Rev. Proc. 98–22 for rules relating to other taxes and penalties.

.04 *Reliance.* Taxpayers may rely on this revenue procedure, including the relief described in section 2.01.

### SECTION 3. DEFINITIONS

The following definitions apply for purposes of this revenue procedure.

.01 *403(b) Plan.* The term "403(b) Plan" means a plan or program intended to satisfy the requirements of § 403(b), including a Plan of an Ineligible Employer.

.02 *Demographic Failure.* The term "Demographic Failure" means, with respect to a 403(b) Plan, a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i)).

.03 *Eligibility Failure.* The term "Eligibility Failure" means, with respect to a 403(b) Plan, any of the following:

(1) A Plan of an Ineligible Employer;

(2) A failure to satisfy the nontransferability requirement of § 401(g);

(3) A failure to initially establish or maintain a custodial account as required by § 403(b)(7); or

(4) A failure to purchase (initially or subsequently) either an annuity contract from an insurance company (unless grandfathered under Rev. Rul. 82–102, 1982–1 C.B. 62) or a custodial account from a regulated investment company utilizing a bank or an approved non-bank trustee/custodian.

.04 *Excess Amounts.* The term "Excess Amounts" means any contributions or allocations to a 403(b) Plan that are in excess of the limits under § 415 or § 403(b)(2) (the exclusion allowance limit) for the year.

.05 *Operational Failure*. The term "Operational Failure" means, with respect to a 403(b) Plan, any of the following:

(1) A failure to satisfy the requirements in § 403(b)(12)(A)(ii) (relating to the availability of salary reduction contributions);

(2) A failure to satisfy the requirements of § 401(m) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i));

(3) A failure to satisfy the requirements of § 401(a)(17) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i));

(4) A failure to satisfy the distribution restrictions of § 403(b)(7) or § 403(b)(11);

(5) A failure to satisfy the incidental death benefit rules of § 403(b)(10);

(6) A failure to pay minimum required distributions under § 403(b)(10);

(7) A failure to give employees the right to elect a direct rollover under § 403(b)(10), including the failure to give meaningful notice of such right;

(8) A failure to satisfy the limit on elective deferrals under § 403(b)(1)(E);

(9) A failure involving contributions or allocations of Excess Amounts; or

(10) Any other failure to satisfy applicable requirements under § 403(b) that (a) results in the loss of § 403(b) status for the plan or the loss of § 403(b) status for the custodial account(s) or annuity contract(s) under the plan and (b) is not a Demographic Failure, an Eligibility Failure, or a failure related to the purchase of annuity contracts, or contributions to custodial accounts, on behalf of individuals who are not employees of the employer.

.06 *Plan of an Ineligible Employer.* The term "Plan of an Ineligible Employer" means a plan intended to satisfy the requirements of § 403(b) but which is not eligible for favorable tax treatment under § 403(b) because the employer is not a tax-exempt organization described in § 501(c)(3) or a public educational organization described in § 170(b)(1)(A)(ii).

.07 *Total Sanction Amount.* The term "Total Sanction Amount" means a monetary amount that is approximately equal to the income tax the Service could collect as a result of the failure.

**SECTION 4. CORRECTION METHODS**

.01 *In general.* The correction principles and rules of general applicability described in Section 6 of Rev. Proc. 98–22 apply to 403(b) Plans, except as provided in sections 4.02 and 4.03 below. Thus, a failure with respect to a 403(b) Plan is generally not corrected unless correction is made with respect to all participants and beneficiaries for all taxable years pursuant to this revenue procedure.

.02 *Correction of Excess Amounts*. Excess Amounts may be corrected only pursuant to paragraph (1) or (2) of this section 4.02.

(1) Distribution of Excess Amounts. In order to correct under this paragraph (1), Excess Amounts for a year, adjusted for earnings through the date of distribution, must be distributed to affected participants and beneficiaries and are includible in their gross income in the year distributed. A distribution of Excess Amounts is generally treated in the manner described in Section 3 of Rev. Proc. 92–93, 1992–2 C.B. 505, relating to the corrective disbursement of elective deferrals. The distribution must be reported on Forms 1099-R for the year of distribution with respect to each participant or beneficiary receiving such a distribution. The distribution of Excess Amounts is not an eligible rollover distribution within the meaning of § 403(b)(8). In addition, the employer must inform affected participants and beneficiaries that the distribution of Excess Amounts is not eligible for rollover. Excess Amounts distributed pursuant to this paragraph (1) are not treated as amounts previously excludable under § 403(b)(2)(A)(ii) for purposes of calculating the maximum exclusion allowance for the taxable year of the distribution and for subsequent taxable years.

(2) Retention of Excess Amounts. Alternatively, only under TVC and Audit CAP for 403(b) Plans, Excess Amounts will be treated as corrected (even though the Excess Amounts are retained in the 403(b) Plan) if the requirements of this paragraph (2) are satisfied. Excess Amounts arising from a § 415 failure, adjusted for earnings through the date of correction, must reduce affected participants' applicable § 415 limit for the year following the year of correction (or for the year of correction if the employer so chooses), and subsequent years, until the excess is eliminated. Excess Amounts (whether arising from a § 415 failure or a § 403(b)(2) failure), adjusted for earnings through the date of correction, must also reduce participants' exclusion allowances by being treated as amounts previously excludable under § 403(b)(2)(A)(ii) beginning with the year following the year of correction (or the year of correction if the employer so chooses). The correction described in this paragraph (2) must generally be used for all participants who have Excess Amounts. See section 8.03 below for the correction compliance fee that is generally applicable to Excess Amounts corrected pursuant to this paragraph (2).

.03 *Correction of a Plan of an Ineligible Employer.* The permitted correction of a Plan of an Ineligible Employer under TVC is the cessation of all contributions (including salary reduction and after-tax contributions) beginning no later than the date the application under TVC is filed. Pursuant to TVC correction, the assets in such a plan are to remain in the annuity contract or custodial account and are to be distributed no earlier than the occurrence of one of the distribution events described in § 403(b)(7) (to the extent the assets are held in custodial accounts) or § 403(b)-(11) (for those assets invested in annuity contracts that would be subject to § 403(b)(11) restrictions if the employer were eligible). A Plan of an Ineligible Employer that is corrected through TVC will be treated as subject to all of the requirements and provisions of § 403(b), including the provisions of § 403(b)(8) (relating to rollovers). Because a Plan of an Ineligible Employer will be treated as subject to all of the requirements of § 403(b), the plan must, as part of TVC correction, also correct all other Operational, Demographic, and Eligibility Failures in accordance with this revenue procedure. The correction of a Plan of an Ineligible Employer is subject to the fee described in section 8.04 below (or, with respect to the correction of multiple failures, section 8.05 below).

**SECTION 5. SELF-CORRECTION (APRSC)**

.01 *In general.* Except as provided in section 5.02 below, the provisions of Sections 7, 8, and 9 of Rev. Proc. 98-22 generally apply for purposes of self-correcting a 403(b) Plan.

.02 *Special rules for APRSC.*

(1) APRSC is available to correct Operational Failures, but is not available to correct Demographic Failures or Eligibility Failures.

(2) A plan document is neither necessary nor sufficient to demonstrate that the employer, plan administrator, or insurer has in place established practices and procedures reasonably designed to facilitate overall compliance.

(3) To be eligible for APRSC, there is no requirement that the employer obtain a private letter ruling from the Service covering its 403(b) Plan. Section 4.03 of Rev. Proc. 98–22 does not apply.

(4) APRSC is available to correct Excess Amounts using the method described in section 4.02(1) above, but not the method described in section 4.02(2) above.

(5) To be eligible for APRSC, an employer must have (either directly or, where appropriate, through the insurer or custodian of the annuity contracts or custodial accounts under the 403(b) Plan) compliance practices and procedures in accordance with Section 4.04 of Rev. Proc. 98–22.

(6) APRSC is not available to correct Operational Failures that are egregious, Operational Failures relating to a diversion or misuse of plan assets, or other Operational Failures that are not eligible for correction under APRSC in accordance with Rev. Proc. 98–22.

## SECTION 6. TVC PROGRAM

.01 *In general.* TVC generally allows employers to submit an application requesting correction of one or more Operational Failures, Demographic Failures, or Eligibility Failures. Under TVC, the employer pays a compliance correction fee, as described in section 8 below, and corrects the failures identified in accordance with the terms of a closing agreement entered into by the Service and the employer. Payment of the compliance correction fee is generally required at the time the closing agreement is signed. Depending on the nature of the failure and the plan's existing administrative procedures, the closing agreement may be conditioned on the implementation of stated administrative procedures.

.02 *TVC requirements.* The provisions of Rev. Proc. 98–22 relating to Walk-in CAP generally apply to TVC except that TVC applies to Operational Failures, Demographic Failures, and Eligibility Failures in a 403(b) Plan. In addition, there is no requirement that the employer obtain a private letter ruling from the Service covering its 403(b) Plan. Section 4.03 of Rev. Proc. 98–22 does not apply.

.03 *Eligibility for TVC.* TVC is not available if the 403(b) Plan or the employer is Under Examination.

.04 *Failures covered by TVC.* TVC is expanded to cover all Operational Failures, Demographic Failures, and Eligibility Failures that are within the jurisdiction of the EP/EO Division of the Key District Office, including Plans of Ineligible Employers. TVC is available to correct egregious failures; however, these failures are subject to the fee described in section 8.06 below. TVC is not available with respect to failures relating to the diversion or misuse of plan assets.

.05 *Correction of Excess Amounts.* Failures related to Excess Amounts may be corrected under TVC in the manner described in paragraph (1) or (2) of section 4.02 above, and are subject to the fee described in section 8.02 or 8.03, respectively.

## SECTION 7. APPLICATION PROCEDURES FOR TVC

.01 *In general.* The procedures and submission requirements of Section 12 of Rev. Proc. 98–22 apply for purposes of TVC.

.02 *Submission requirements.* In addition to the submission requirements provided in Section 12.03 of Rev. Proc. 98–22, an application under TVC must contain a statement that the employer has contacted all other entities involved with the plan and has been assured of cooperation in implementing the applicable correction, to the extent necessary. For example, if the plan's failure is the failure to satisfy the requirements of § 403(b)(1)(E) on elective deferrals, the employer must, prior to making the TVC application, contact the insurance company or custodian with control over the plan's assets to assure cooperation in effecting a distribution of the excess deferrals and the earnings thereon.

.03 *Required documents.* A TVC submission must be accompanied by the following documents:

(1) If applicable, the first two pages of the most recently filed Form 5500, or if inapplicable, the information generally included on the first two pages, including the name and number of the plan, and the employer's Employer Identification Number.

(2) A statement as to the type of employer (e.g., a tax- exempt organization described in § 501(c)(3)) submitting the TVC application.

(3) A copy of the pertinent portions of any relevant § 403(b) documents such as plan documents, written descriptions of the plan, and sample salary reduction agreements.

(4) The letter to the Service requesting consideration under TVC must be designated "TVC PROGRAM."

(5) TVC submissions must be mailed to the Closing Agreement Coordinator in the appropriate Key District Office as provided in Section 12.12 of Rev. Proc. 98–22.

.04 *Checklist.* A checklist in Appendix B of Rev. Proc. 98–22 is provided for use by an employer in preparing a TVC request.

## SECTION 8. FEES FOR TVC

.01 *TVC compliance correction fee.* The applicable TVC compliance correction fee depends on the type of failure and, generally, the number of employees of the employer.

.02 *Fee for Operational Failures.* Subject to section 8.05 below, the compliance correction fees for Operational Failures are as follows:

(1) The fee for an employer with fewer than 25 employees is $500.

(2) The fee for an employer with at least 25 and no more than 1,000 employees is $1,250.

(3) The fee for an employer with more than 1,000 employees but less than 10,000 is $5,000.

(4) The fee for an employer with 10,000 or more employees is $10,000.

.03 *Fee for certain Excess Amounts.* Subject to section 8.05 below, the compliance correction fee for Excess Amounts that are corrected pursuant to section 4.02(2) above is equal to the sum of (1) the applicable fee described in section 8.02 above and (2) two percent of the Excess Amounts, adjusted for earnings through the date of the TVC application, contributed or allocated in the calendar year of the TVC application and in the three calendar years prior thereto. For purposes of determining the fee described in this section 8.03, where there is a failure to satisfy both the § 403(b)(2) and § 415 limits with respect to a single employee for a year, the fee will take into account only the greater Excess Amount.

.04 *Fee for Demographic and Eligibility Failures.* (1) Subject to section 8.05 below, the compliance correction fee for a 403(b) Plan with failures that include Demographic or Eligibility Failures is determined in accordance with the table set forth below. It is expected that in most instances the compliance correction fee imposed will be at or near the presumptive amount in each range; however, the fee may be a higher or lower amount within the range, depending on the factors in paragraph (2) below. This table is the same as the table provided in Section 13.05 of Rev. Proc. 98–22, except that (a) the reference to the "VCR fee" is changed to refer to the TVC compliance correction fee for Operational Failures set forth in section 8.02 above, and (b) the fee is determined with reference to the number of employees rather than participants.

**FEES FOR DEMOGRAPHIC AND ELIGIBILITY FAILURES**

| # of employees | Fee range | Presumptive Amount |
|---|---|---|
| 10 or fewer | TVC fee for Operational Failures to $4,000 | $2,000 |
| 11 to 50 | TVC fee for Operational Failures to $8,000 | $4,000 |
| 51 to 100 | TVC fee for Operational Failures to $12,000 | $6,000 |
| 101 to 300 | TVC fee for Operational Failures to $16,000 | $8,000 |
| 301 to 1,000 | TVC fee for Operational Failures to $30,000 | $15,000 |
| Over 1,000 | TVC fee for Operational Failures to $70,000 | $35,000 |

(2) Consideration of whether the compliance correction fee for a 403(b) Plan with failures that include Demographic or Eligibility Failures should be equal to, greater than, or less than the presumptive amount set forth in section 8.04(1) above will depend on factors relating to the nature, extent, and severity of the failure. These factors include: (a) whether the failure is a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b) (pursuant to § 403(b)(12)(A)(i)); (b) whether the plan is a Plan of an Ineligible Employer; (c) whether the 403(b) Plan has a combination of Operational, Demographic, and Eligibility failures; and (d) the period of time over which the failure occurred.

.05 *Fee for multiple failures.* If correction is requested for multiple failures, the compliance correction fee will be determined in accordance with the table set forth below.

| | |
|---|---|
| Multiple Operational Failures | Fee described in section 8.02 |
| Multiple Demographic/Eligibility Failures | Fee described in section 8.04 |
| Combination of Operational and Demographic/Eligibility Failures | Fee described in section 8.04 |
| Operational Failure(s) with section 4.02(2) correction of Excess Amounts | Fee described in section 8.03 |
| Demographic/Eligibility Failures and Operational Failures including section 4.02(2) correction of Excess Amounts | Fee described in section 8.03, substituting section 8.04 fee for section 8.02 fee |

.06 *Fee for egregious failures.* Consistent with section 13.05(3) of Rev. Proc. 98–22, in cases involving failures that are egregious, the maximum compliance correction fee applicable to the plan is increased to 40 percent of the Total Sanction Amount and no presumptive amount applies.

### SECTION 9. AUDIT CAP FOR 403(B) PLANS

.01 *Audit CAP requirements*. The provisions of Sections 14 and 15 of Rev. Proc. 98–22 are expanded to cover 403(b) Plans. Thus, in the event the Service identifies an Operational Failure, Demographic Failure, or an Eligibility Failure upon an Employee Plans or Exempt Organizations examination (other than a failure that has been corrected under APRSC or TVC or that is eligible for correction under APRSC), the requirements of Section 14 of Rev. Proc. 98–22 are satisfied with respect to the failure if the employer corrects the failure, pays a sanction in accordance with section 9.02 below, adopts appropriate administrative procedures, and enters into a closing agreement with the Service. Audit CAP for 403(b) Plans is not available for failures relating to a misuse or diversion of plan assets.

.02 *Payment of sanction.* The sanction under Audit CAP for 403(b) Plans is a negotiated percentage of the Total Sanction Amount. Sanctions will not be excessive and will bear a reasonable relationship to the nature, extent, and severity of the failures. The amount of the sanction will depend on factors relating to the nature, extent, and severity of the failures, including the extent to which correction had progressed before the examination was initiated. Other factors relating to the nature, extent, and severity of the failures include: (1) the number and type of employees affected by the failure; (2) the number of nonhighly compensated employees who would be adversely affected if the plan were not treated as a plan described in § 403(b); (3) whether the failure is a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b) (pursuant to § 403(b)(12)(A)(i)); (4) the extent to which the failure relates to Excess Amounts; (5) whether the plan is a Plan of an Ineligible Employer; (6) whether the plan has a combination of Operational, Demographic, or Eligibility Failures; (7) the period over which the failure occurred; and (8) the reason for the failure (for example, data errors such as errors in transcription of data, the transposition of numbers, or minor arithmetic errors).

### SECTION 10. EFFECT ON OTHER DOCUMENTS

.01 Except as provided in section 11 below, the TVC program described in Rev. Procs. 95-24 and 96-50 is modified and superseded by this revenue procedure.

.02 Rev. Proc. 99–8, 1999–1 I.R.B. 229, is modified as provided in section 8 of this revenue procedure.

.03 Rev. Proc. 98–22 is modified and amplified by this revenue procedure.

### SECTION 11. EFFECTIVE DATE

The effective date of this revenue procedure is January 1, 1999. However, a TVC application made on or after January 1, 1999 and prior to July 1, 1999 will be reviewed under the guidance provided in Rev. Procs. 95–24 and 96–50, unless the applicant indicates that the TVC application should be reviewed under the guidance provided in this revenue procedure. TVC applications made on and after July 1, 1999 will in all cases be reviewed in accordance with the guidance provided in this revenue procedure.

### SECTION 12. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1645.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information in this revenue procedure is in sections 1.01, 4.02, 4.03, 6.01, 6.02, 6.04, 6.05, 7.01–7.04, and 9.01 of this revenue procedure. This information is required to enable the Office of Assistant Commissioner (Employee Plans and Exempt Organizations) of the Internal Revenue Service to make determinations regarding the issuance of various types of closing agreements. This information will be used to issue closing agreements to allow individual plans to continue to maintain their tax qualified status. As a result, favorable tax treatment of the benefits of the eligible employees is retained. The likely respondents are state or local governments and nonprofit institutions.

The estimated total annual reporting and/or recordkeeping burden is 1,899 hours.

The estimated annual burden per respondent/recordkeeper varies from .5 to 12 hours, depending on individual circumstances, with an estimated average of 3.8 hours. The estimated number of respondents and/or recordkeepers is 500.

The estimated frequency of responses is occasionally.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### DRAFTING INFORMATION

The principal author of this revenue procedure is Rosamond S. Ferber of the Employee Plans Division. For more information concerning this revenue procedure, call the Employee Plans Division Telephone Number, (202) 622-6074 or (202) 622-6075 (not a toll-free number) between the hours of 1:30 and 4:00 pm, Monday through Thursday. Ms. Ferber may be reached at (202) 622-6214 (also not a toll-free number).

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*26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.*
*(Also Part I, § 280F; 1.280F–7, 1.61–21.)*

## Rev. Proc. 99–14

SECTION 1. PURPOSE

This revenue procedure provides: (1) limitations on depreciation deductions for owners of passenger automobiles first placed in service during calendar year 1999, including separate limitations on passenger automobiles designed to be propelled primarily by electricity and built by an original equipment manufacturer (electric automobiles); (2) the amounts to be included in income by lessees of passenger automobiles first leased during calendar year 1999, including separate inclusion amounts for electric automobiles; and (3) the maximum allowable value of employer-provided automobiles first made available to employees for personal use in calendar year 1999 for which the vehicle cents-per-mile valuation rule provided under § 1.61-21(e) of the Income Tax Regulations may be applicable. The tables detailing these depreciation limitations and lessee inclusion amounts reflect the automobile price inflation adjustments required by § 280F(d)(7) of the Internal Revenue Code. The maximum allowable automobile value for applying the vehicle cents-per-mile valuation rule reflects the automobile price inflation adjustment of § 280F(d)(7) as required by § 1.61–21(e)(1)(iii)(A).

SECTION 2. BACKGROUND

For owners of automobiles, § 280F(a) imposes dollar limitations on the depreciation deduction for the year that the automobile is placed in service and each succeeding year. In the case of electric automobiles placed in service after August 5, 1997, and before January 1, 2005, § 280F(a)(1)(C) requires tripling of these limitation amounts. Section 280F(d)(7) requires the amounts allowable as depreciation deductions to be increased by a price inflation adjustment amount for passenger automobiles placed in service after calendar year 1988.

For leased automobiles, § 280F(c) requires a reduction in the deduction allowed to the lessee of the automobile. The reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of automobiles. Under § 1.280F–7(a), this reduction requires the lessees to include in gross income an inclusion amount

determined by applying a formula to the amount obtained from a table. There is a table for lessees of electric automobiles and a table for all other passenger automobiles. Each table shows inclusion amounts for a range of fair market values for each tax year after the automobile is first leased.

For automobiles first provided by employers to employees that meet the requirements of § 1.61–21(e)(1), the value to the employee of the use of the automobile may be determined under the vehicle cents-per-mile valuation rule of § 1.61–21(e). Section 1.61–21(e)(1)(iii)(A) provides that for an automobile first made available after 1988 to any employee of the employer for personal use, the value of the use of the automobile may not be determined under the vehicle cents-per-mile valuation rule for a calendar year if the fair market value of the automobile (determined pursuant to § 1.61–21(d)(5)(i) through (iv)) on the first date the automobile is made available to the employee exceeds $12,800 as adjusted by § 280F(d)(7).

SECTION 3. SCOPE AND OBJECTIVE

01. The limitations on depreciation deductions in section 4.02 of this revenue procedure apply to automobiles (other than leased automobiles) that are placed in service in calendar year 1999 and continue to apply for each tax year that the automobile remains in service.

02. The tables in section 4.03 of this revenue procedure apply to leased automobiles for which the lease term begins in calendar year 1999. Lessees of such automobiles must use these tables to determine the inclusion amount for each tax year during which the automobile is leased.

03. *See* Rev. Proc. 96–25, 1996–1 C.B. 681, for information on determining inclusion amounts for automobiles first leased before January 1, 1997; Rev. Proc. 97–20, 1997–1 C.B. 647, for automobiles first leased during calendar year 1997, including electric automobiles first leased on or after January 1, 1997, and before August 6, 1997; Rev. Proc. 98–24, 1998–10 I.R.B. 31, for electric automobiles first leased after August 5, 1997, and before January 1, 1998; and Rev. Proc. 98–30, 1998–17 I.R.B. 6, for all automobiles first leased in calendar year 1998.

04. The maximum fair market value figure in section 4.04(2) of this revenue procedure applies to employer-provided automobiles first made available to any employee for personal use in calendar year 1999. *See* Rev. Proc. 97–20, for the maximum fair market value figure for automobiles first made available in calendar year 1997; and Rev. Proc. 98–30, for the maximum fair market value figure for automobiles first made available in calendar year 1998.

SECTION 4. APPLICATION

01. A taxpayer placing an automobile in service for the first time during calendar year 1999 is limited to the depreciation deduction shown in Table 1 of section 4.02(2) or, in the case of an electric automobile, Table 2. A taxpayer first leasing an automobile in calendar year 1999 must determine the inclusion amount that is added to gross income using Table 3 of section 4.03 or, in the case of an electric automobile, Table 4. Otherwise, the procedures of § 1.280F–7(a) must be followed. An employer providing an automobile for the first time in calendar year 1999 for the personal use of any employee may determine the value of the use of the automobile by using the cents-per-mile valuation rule in § 1.61-21(e) if the fair market value of the automobile does not exceed the amount specified in section 4.04(2). If the fair market value of the automobile exceeds the amount specified in section 4.04(2), the employer may determine the value of the use of the automobile under the general valuation rules of § 1.61–21(b) or under the special valuation rules of § 1.61-21(d) (Automobile lease valuation) or § 1.61–21(f) (Commuting valuation) if the applicable requirements are met.

02. *Limitations on Depreciation Deductions for Certain Automobiles.*

(1) *Amount of the Inflation Adjustment.* Under § 280F(d)(7)(B)(i), the automobile price inflation adjustment for any calendar year is the percentage (if any) by which the CPI automobile component for October of the preceding calendar year exceeds the CPI automobile component for October 1987. The term “CPI automobile component” is defined in § 280F(d)(7)(B)(ii) as the “automobile component” of the Consumer Price Index for all Urban Consumers published by the Department of Labor (the CPI). The new car component of the CPI was 115.2 for October 1987 and 139.7 for October 1998. The October 1998 index exceeded the October 1987 index by 24.5. The Internal Revenue Service has, therefore, determined that the automobile price inflation adjustment for 1999 is 21.27 percent

(24.5/115.2 × 100%). This adjustment is applicable to all automobiles that are first placed in service in calendar year 1999. The dollar limitations in § 280F(a) must therefore be multiplied by a factor of 0.2127, and the resulting increases, after rounding to the nearest $100, are added to the 1988 limitations to give the depreciation limitations applicable to passenger automobiles (other than electric automobiles) for 1999. To determine the dollar limitations applicable to an electric automobile first placed in service during calendar year 1999, the dollar limitations in § 280F(a) are tripled in accordance with § 280F(a)(1)(C) and are then multiplied by a factor of 0.2127; the resulting increases, after rounding to the nearest $100, are added to the tripled 1988 limitations to give the depreciation limitations for 1999.

(2) *Amount of the Limitation.* For automobiles (other than electric automobiles) placed in service in calendar year 1999, Table 1 contains the dollar amount of the depreciation limitations for each tax year. For electric automobiles placed in service in calendar year 1999, Table 2 contains these amounts.

REV. PROC. 99–14 TABLE 1

DEPRECIATION LIMITATIONS FOR AUTOMOBILES (OTHER THAN ELECTRIC AUTOMOBILES) FIRST PLACED IN SERVICE IN CALENDAR YEAR 1999

| *Tax Year* | *Amount* |
|---|---|
| 1st Tax Year | $3,060 |
| 2nd Tax Year | $5,000 |
| 3rd Tax Year | $2,950 |
| Each Succeeding Year | $1,775 |

REV. PROC. 99–14 TABLE 2

DEPRECIATION LIMITATIONS FOR ELECTRIC AUTOMOBILES FIRST PLACED IN SERVICE IN CALENDAR YEAR 1999

| *Tax Year* | *Amount* |
|---|---|
| 1st Tax Year | $9,280 |
| 2nd Tax Year | $14,900 |
| 3rd Tax Year | $8,950 |
| Each Succeeding Year | $5,325 |

03. *Inclusions in Income of Lessees of Automobiles.*

The inclusion amounts for automobiles first leased in calendar year 1999 are calculated under the procedures described in § 1.280F–7(a). Lessees of automobiles other than electric automobiles should use Table 3 in applying these procedures, while lessees of electric automobiles should use Table 4.

REV. PROC. 99–14 TABLE 3

DOLLAR AMOUNTS FOR AUTOMOBILES (OTHER THAN ELECTRIC AUTOMOBILES) WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1999

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | 1st | 2nd | 3rd | 4th | 5th and Later |
| $ 15,500 | 15,800 | 2 | 3 | 4 | 4 | 6 |
| 15,800 | 16,100 | 4 | 7 | 10 | 13 | 14 |
| 16,100 | 16,400 | 6 | 11 | 17 | 20 | 23 |
| 16,400 | 16,700 | 8 | 15 | 23 | 28 | 32 |
| 16,700 | 17,000 | 10 | 20 | 29 | 35 | 41 |
| 17,000 | 17,500 | 13 | 25 | 38 | 45 | 53 |

REV. PROC. 99–14 TABLE 3

DOLLAR AMOUNTS FOR AUTOMOBILES (OTHER THAN ELECTRIC AUTOMOBILES)
WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1999

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | 1st | 2nd | 3rd | 4th | 5th and Later |
| 17,500 | 18,000 | 16 | 32 | 48 | 58 | 68 |
| 18,000 | 18,500 | 19 | 39 | 59 | 71 | 82 |
| 18,500 | 19,000 | 22 | 47 | 69 | 83 | 96 |
| 19,000 | 19,500 | 26 | 53 | 80 | 96 | 111 |
| 19,500 | 20,000 | 29 | 61 | 90 | 108 | 126 |
| 20,000 | 20,500 | 32 | 68 | 101 | 121 | 140 |
| 20,500 | 21,000 | 35 | 75 | 111 | 134 | 155 |
| 21,000 | 21,500 | 39 | 82 | 122 | 146 | 169 |
| 21,500 | 22,000 | 42 | 89 | 132 | 160 | 183 |
| 22,000 | 23,000 | 47 | 100 | 148 | 178 | 206 |
| 23,000 | 24,000 | 53 | 114 | 169 | 204 | 235 |
| 24,000 | 25,000 | 60 | 128 | 190 | 229 | 264 |
| 25,000 | 26,000 | 66 | 142 | 212 | 254 | 293 |
| 26,000 | 27,000 | 73 | 156 | 233 | 279 | 322 |
| 27,000 | 28,000 | 79 | 171 | 253 | 305 | 351 |
| 28,000 | 29,000 | 85 | 185 | 275 | 330 | 380 |
| 29,000 | 30,000 | 92 | 199 | 296 | 355 | 410 |
| 30,000 | 31,000 | 98 | 214 | 316 | 381 | 439 |
| 31,000 | 32,000 | 105 | 227 | 338 | 406 | 468 |
| 32,000 | 33,000 | 111 | 242 | 359 | 431 | 497 |
| 33,000 | 34,000 | 118 | 256 | 380 | 456 | 527 |
| 34,000 | 35,000 | 124 | 270 | 402 | 481 | 556 |
| 35,000 | 36,000 | 131 | 284 | 423 | 506 | 585 |
| 36,000 | 37,000 | 137 | 299 | 443 | 532 | 614 |
| 37,000 | 38,000 | 144 | 313 | 464 | 557 | 643 |
| 38,000 | 39,000 | 150 | 327 | 486 | 582 | 672 |
| 39,000 | 40,000 | 157 | 341 | 507 | 607 | 702 |
| 40,000 | 41,000 | 163 | 355 | 528 | 633 | 731 |
| 41,000 | 42,000 | 170 | 369 | 549 | 658 | 760 |
| 42,000 | 43,000 | 176 | 384 | 570 | 683 | 789 |
| 43,000 | 44,000 | 183 | 398 | 591 | 708 | 819 |
| 44,000 | 45,000 | 189 | 412 | 612 | 734 | 848 |
| 45,000 | 46,000 | 196 | 426 | 633 | 759 | 877 |
| 46,000 | 47,000 | 202 | 441 | 654 | 784 | 906 |
| 47,000 | 48,000 | 208 | 455 | 675 | 810 | 935 |
| 48,000 | 49,000 | 215 | 469 | 696 | 835 | 964 |
| 49,000 | 50,000 | 221 | 483 | 718 | 860 | 993 |
| 50,000 | 51,000 | 228 | 497 | 739 | 885 | 1,023 |
| 51,000 | 52,000 | 234 | 512 | 759 | 911 | 1,052 |
| 52,000 | 53,000 | 241 | 526 | 780 | 936 | 1,081 |
| 53,000 | 54,000 | 247 | 540 | 802 | 961 | 1,110 |
| 54,000 | 55,000 | 254 | 554 | 823 | 986 | 1,140 |
| 55,000 | 56,000 | 260 | 569 | 843 | 1,012 | 1,169 |
| 56,000 | 57,000 | 267 | 582 | 865 | 1,037 | 1,198 |
| 57,000 | 58,000 | 273 | 597 | 886 | 1,062 | 1,227 |
| 58,000 | 59,000 | 280 | 611 | 907 | 1,087 | 1,256 |
| 59,000 | 60,000 | 286 | 625 | 928 | 1,113 | 1,285 |
| 60,000 | 62,000 | 296 | 646 | 960 | 1,151 | 1,329 |
| 62,000 | 64,000 | 309 | 675 | 1,002 | 1,201 | 1,387 |

REV. PROC. 99–14 TABLE 3

DOLLAR AMOUNTS FOR AUTOMOBILES (OTHER THAN ELECTRIC AUTOMOBILES) WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1999

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | 1st | 2nd | 3rd | 4th | 5th and Later |
| 64,000 | 66,000 | 322 | 703 | 1,044 | 1,252 | 1,446 |
| 66,000 | 68,000 | 335 | 732 | 1,086 | 1,302 | 1,504 |
| 68,000 | 70,000 | 348 | 760 | 1,128 | 1,353 | 1,563 |
| 70,000 | 72,000 | 361 | 788 | 1,171 | 1,403 | 1,621 |
| 72,000 | 74,000 | 374 | 817 | 1,212 | 1,454 | 1,679 |
| 74,000 | 76,000 | 387 | 845 | 1,255 | 1,504 | 1,738 |
| 76,000 | 78,000 | 399 | 874 | 1,297 | 1,555 | 1,796 |
| 78,000 | 80,000 | 412 | 902 | 1,339 | 1,606 | 1,854 |
| 80,000 | 85,000 | 435 | 952 | 1,413 | 1,694 | 1,956 |
| 85,000 | 90,000 | 467 | 1,023 | 1,518 | 1,821 | 2,102 |
| 90,000 | 95,000 | 500 | 1,094 | 1,623 | 1,947 | 2,248 |
| 95,000 | 100,000 | 532 | 1,165 | 1,729 | 2,073 | 2,394 |
| 100,000 | 110,000 | 581 | 1,271 | 1,887 | 2,263 | 2,612 |
| 110,000 | 120,000 | 645 | 1,414 | 2,097 | 2,516 | 2,904 |
| 120,000 | 130,000 | 710 | 1,556 | 2,308 | 2,768 | 3,196 |
| 130,000 | 140,000 | 775 | 1,697 | 2,519 | 3,021 | 3,488 |
| 140,000 | 150,000 | 840 | 1,839 | 2,730 | 3,274 | 3,779 |
| 150,000 | 160,000 | 904 | 1,982 | 2,940 | 3,526 | 4,072 |
| 160,000 | 170,000 | 969 | 2,124 | 3,151 | 3,779 | 4,363 |
| 170,000 | 180,000 | 1,034 | 2,265 | 3,362 | 4,032 | 4,655 |
| 180,000 | 190,000 | 1,099 | 2,407 | 3,573 | 4,284 | 4,947 |
| 190,000 | 200,000 | 1,163 | 2,550 | 3,783 | 4,537 | 5,238 |
| 200,000 | 210,000 | 1,228 | 2,692 | 3,994 | 4,789 | 5,530 |
| 210,000 | 220,000 | 1,293 | 2,833 | 4,205 | 5,043 | 5,822 |
| 220,000 | 230,000 | 1,358 | 2,975 | 4,416 | 5,295 | 6,114 |
| 230,000 | 240,000 | 1,422 | 3,118 | 4,626 | 5,548 | 6,405 |
| 240,000 | 250,000 | 1,487 | 3,260 | 4,837 | 5,800 | 6,697 |

REV. PROC. 99–14 TABLE 4

DOLLAR AMOUNTS FOR ELECTRIC AUTOMOBILES
WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1999

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | 1st | 2nd | 3rd | 4th | 5th and Later |
| $ 47,000 | 48,000 | 7 | 14 | 21 | 26 | 30 |
| 48,000 | 49,000 | 14 | 28 | 42 | 51 | 59 |
| 49,000 | 50,000 | 20 | 43 | 62 | 77 | 88 |
| 50,000 | 51,000 | 27 | 57 | 83 | 102 | 118 |
| 51,000 | 52,000 | 33 | 71 | 105 | 127 | 147 |
| 52,000 | 53,000 | 39 | 86 | 126 | 151 | 177 |
| 53,000 | 54,000 | 46 | 100 | 147 | 177 | 205 |
| 54,000 | 55,000 | 52 | 114 | 168 | 202 | 235 |
| 55,000 | 56,000 | 59 | 128 | 189 | 228 | 264 |
| 56,000 | 57,000 | 65 | 142 | 211 | 253 | 292 |
| 57,000 | 58,000 | 72 | 156 | 232 | 278 | 322 |
| 58,000 | 59,000 | 78 | 171 | 252 | 304 | 351 |
| 59,000 | 60,000 | 85 | 185 | 273 | 329 | 380 |
| 60,000 | 62,000 | 95 | 206 | 305 | 367 | 424 |
| 62,000 | 64,000 | 107 | 235 | 347 | 417 | 483 |
| 64,000 | 66,000 | 120 | 263 | 389 | 468 | 541 |
| 66,000 | 68,000 | 133 | 291 | 432 | 518 | 600 |
| 68,000 | 70,000 | 146 | 320 | 473 | 569 | 658 |
| 70,000 | 72,000 | 159 | 348 | 516 | 619 | 716 |
| 72,000 | 74,000 | 172 | 377 | 558 | 669 | 775 |
| 74,000 | 76,000 | 185 | 405 | 600 | 720 | 833 |
| 76,000 | 78,000 | 198 | 433 | 643 | 771 | 891 |
| 78,000 | 80,000 | 211 | 462 | 684 | 822 | 949 |
| 80,000 | 85,000 | 234 | 511 | 758 | 910 | 1,052 |
| 85,000 | 90,000 | 266 | 582 | 864 | 1,036 | 1,198 |
| 90,000 | 95,000 | 298 | 654 | 968 | 1,163 | 1,343 |
| 95,000 | 100,000 | 331 | 724 | 1,075 | 1,289 | 1,489 |
| 100,000 | 110,000 | 379 | 831 | 1,232 | 1,479 | 1,708 |
| 110,000 | 120,000 | 444 | 973 | 1,443 | 1,731 | 2,000 |
| 120,000 | 130,000 | 509 | 1,115 | 1,654 | 1,984 | 2,291 |
| 130,000 | 140,000 | 574 | 1,257 | 1,864 | 2,237 | 2,583 |
| 140,000 | 150,000 | 638 | 1,399 | 2,075 | 2,490 | 2,875 |
| 150,000 | 160,000 | 703 | 1,541 | 2,286 | 2,742 | 3,167 |
| 160,000 | 170,000 | 768 | 1,683 | 2,497 | 2,994 | 3,459 |
| 170,000 | 180,000 | 833 | 1,825 | 2,707 | 3,248 | 3,750 |
| 180,000 | 190,000 | 897 | 1,967 | 2,918 | 3,500 | 4,042 |
| 190,000 | 200,000 | 962 | 2,109 | 3,129 | 3,753 | 4,333 |
| 200,000 | 210,000 | 1,027 | 2,251 | 3,340 | 4,005 | 4,625 |
| 210,000 | 220,000 | 1,092 | 2,393 | 3,550 | 4,258 | 4,917 |
| 220,000 | 230,000 | 1,156 | 2,535 | 3,761 | 4,511 | 5,209 |
| 230,000 | 240,000 | 1,221 | 2,677 | 3,972 | 4,763 | 5,501 |
| 240,000 | 250,000 | 1,286 | 2,819 | 4,183 | 5,016 | 5,792 |

04. *Maximum Automobile Value for Using the Cents-per- mile Valuation Rule*.

(1) *Amount of Adjustment.* Under § 1.61–21(e)(1)(iii)(A), the limitation on the fair market value of an employer-provided automobile first made available to any employee for personal use after 1988 is to be adjusted in accordance with § 280F(d)(7). Accordingly, the adjustment for any calendar year is the percentage (if any) by which the CPI automobile component for October of the preceding calendar year exceeds the CPI automobile component for October 1987. See, section 4.02(1). The new car component of the CPI was 115.2 for October 1987 and 139.7 for October 1998. The October 1998 index exceeded the October 1987 index by 24.5. The Internal Revenue Service has, therefore, determined that the adjustment for 1999 is 21.27 percent (24.5/115.2 $\times$ 100%). This adjustment is applicable to all employer-provided automobiles first made available to any employee for personal use in calendar year 1999. The maximum fair market value specified in § 1.61–21(e)(1)(iii)(A) must therefore be multiplied by a factor of 0.2127, and the resulting increase, after rounding to the nearest $100, is added to $12,800 to give the maximum value for 1999.

(2) *The Maximum Automobile Value.* For automobiles first made available in calendar year 1999 to any employee of the employer for personal use, the vehicle cents-per-mile valuation rule may be applicable if the fair market value of the automobile on the date it is first made available does not exceed $15,500.

## SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for automobiles (other than leased automobiles) that are first placed in service during calendar year 1999, to leased automobiles that are first leased during calendar year 1999, and to employer-provided automobiles first made available to employees for personal use in calendar year 1999.

## DRAFTING INFORMATION

The principal author of this revenue procedure is Bernard P. Harvey of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding the depreciation limitations and lessee inclusion amounts in this revenue procedure, contact Mr. Harvey at (202) 622-3110; for further information regarding the maximum automobile value for applying the vehicle cents-per-mile valuation rule, contact Ms. Lynne Camillo of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) at (202) 622-6040 (not toll-free calls).

# Part IV. Items of General Interest

## Foundations Status of Certain Organizations

### Announcement 99–10

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

*Former Public Charities.* The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

C and C Outreach, Marrero, LA
Cabin John Baseball Association Inc., Bethesda, MD
Caddo-Bossier Drop Your Guns Inc., Shreveport, LA
Calcasieu Chapter of the Louisiana Council on Child Abuse, Lake Charles, LA
Calcutta Rescue-USA, Memphis, TN
Calhoun County Crime Stoppers Inc., Port Lavaca, TX
California Alliance Against Domestic Violence, Modesto, CA
California Association of Leadership Programs, Sunnyvale, CA
California Council to Promote Self-Esteem and Responsibility, Davis, CA
California Wellness Information Network, Sacramento, CA
CALQED, Sacramento, CA
Calument Ecological Park Association, Chicago, IL
Calvary Chapel of Sparks, Sparks, NV
Calvary Community Corporation, Cincinnati, OH
Calvert County Symphonic Orchestra Boosters Club Inc., St. Leonard, MD
Calvert Farmland Trust Inc., Huntingtown, MD
Cambodian Society of Houston, Houston, TX
Cambridge Alliance Inc., Cambridge, MA
Camden Enterprises and Associates Incorporated, Baltimore, MD
Camp Chase Memorial Association Inc., Galloway, OH
Camp Excel, De Rio, TX
Camp Grandir Inc., St. Paul, MN
Camp Gruber Chapel Fund Inc., Oklahoma City, OK
Cancer Foundation, Spokane, WA
Campbell County Cancer Association Inc., Lafollette, TN
Cancer Pain Relief-Utah Inc., Salt Lake City, UT
Cancer Prevention and Treatment Research Institute of Arizona Inc., Fountain Hills, AZ
Canines Assisting People Inc., Tampa, FL
Canoeing for Kids, Columbia, SC
Canus Games Inc., Auburn, NY
Cape Cod Charities, S. Yarmouth, MA
Cape Cod Wildlife Inc., Mashpee, MA
Cape Verdean Cultural Preservation Council Inc., Annandale, VA
Capitol Area Parent Action, Austin, TX
Capitol East Community Development Corporation, Washington, DC
C A P O N-Cincinnati Area Pediatric Nurses, Cincinnati, OH
Cardinal Scholarship Fund, East Orange, NJ
Care Con Foundation, Westerville, OH
Care House Inc., Detroit, MI
Care International Inc., Boston, MA
Career Education Through Role Models, Denver, CO
Caribbean American Community Comprehensive Center Inc., Brooklyn, NY
Caribbean Cultural Association, Portland, OR
Caring & Loving All Special Persons Inc., Rexford, MT
Caring Concepts Inc., Gonzales, TX
Carlisle Center for Violence Prevention Inc., Carlisle, MA
Carnation-Duvall A S A P Together Community Task Force, Carnation, WA
Carney Classic Foundation, Thorton, IL
CAROB Foundation Inc., New York, NY
Carolyn Darch Ministries Inc., Troy, MI
Carpenters Home Improvement Inc., Milwaukee, WI
Carr Fork Volunteer Fire Department Incorporated, Litt Carr, KY
Carteret AIDS Service Advocacy Inc., AKA CASA Inc., Beaufort, NC
Cary Educational Foundation, Cary, NC
Cassio Eastland Marrow Foundation, Florence, AL
Castle Now and Beyond, Merced, CA
Casual Classics, Gastonia, NC
Catoosa Girls Softball Association, Catoosa, OK
Cats Cause We Care Shelter Inc., Rising Star, TX
Cause Action Now Inc., New York, NY
CCH Lincoln-Glenarm Housing Inc., Denver, CO
C E Byrd Band Booster Club, Shreveport, LA
Cecil A Hill Memorial, Austin, TX
Cedar Ridge Resident Council Inc., Houston, TX
Celebration of Books, Huntsville, AL
Celebration of Women, San Diego, CA
C E Ministries Inc., Oklahoma City, OK
Center City South Town Watch, Philadelphia, PA
Center for Asian Indian Newcomers, San Francisco, CA
Center for Biblical Values Inc., Grand Rapids, MI
Center for Character Education Inc., Skokie, IL
Center for Counseling Alcoholics and Addicts, Phoenix, AZ
Center for D U I Rehabilitation and Education Inc., Coral Gables, FL
Center for Effective Organization, Austin, TX
Center for Environmental Initiatives Inc., Atlanta, GA
Center for Gerontology Inc., Ft. Lauderdale, FL
Center for Human Advancement, El Paso, TX
Center for Indonesian Studies Inc., Sussex, WI
Center for Investment Research, Plano, TX
Center for Joyful Living, Thousand Oaks, CA
Center for Personal Exploration, Cedar Rapids, IA
Center for Rebuilding Americas Schools, Palatine, IL
Center for Social Research, Cambridge, MA

Center for Spiritual Growths & Prosperity Corp., New York, NY
Center for the Development of Senior Horizons, Detroit, MI
Center for the New Millennium, Minneapolis, MN
Center for the Study of Tyranny Inc., Kensington, MD
Center for the Study of Harassment of African-American Inc., Washington, DC
Center for Unlimited Possibilities Inc., Valparaiso, IN
Center for Ventures in Girls Education Inc., Wellesley, MA
Centipede Artists Cooperative, Danbury, CT
Central Arizona Charitable Trust, Phoenix, AZ
Central City Affordable Housing, Seattle, WA
Central Coast Support Services Inc., Monterey, CA
Central Crisis Center, Melrose, MN
Central Cultural Andino Inc., Central Falls, RI
Central High School Speech & Debate Parents Club, Davenport, IA
Central Maine Affordable Housing, Bar Harbor, ME
Central Maine Youth Hockey Assn., Greene, ME
Central Ohio Rainforest Action Group, Columbus, OH
Central States Fair, Rapid City, SD
Central Texas Lulac Council No. 4525, Waco, TX
Central Virginia Therapeutic Riding Programs Inc., Lynchburg, VA
Centro Hispano Esperanza Inc., St. Croix, VI
C F M Help A Kid, Melville, NY
Chabad Labavitch of Moscow, Brooklyn, NY
Chace Street School Foundation Charitable TR, Somerset, MA
Challenge Inc., Bath, ME
Challenged People Having Abilities Needing Competitive Employment Inc., Milwaukee, WI
Chamber Development Foundation Inc., Lynn, MA
Chamber Music Society of Seattle, Seattle, WA
Chambers Foundation Incorporated, Indianapolis, IN
Champions for Kids Incorporated, Raleigh, NC
Champlain Rifles, Fair Haven, VT
Champlain Police Association, Champlain, MN
Change the World Inc., Lawrenceville, GA
Changing Direction Inc., Bronx, NY
Channel It Distribution Network Inc., Minneapolis, MN
Charity Family Life, Richmond, VA
Charlotte Als Research & Support Corporation, Charlotte, NC
Charlotte County Hunger Program Inc., Drakes Branch, VA
Charlton Pollard Alumni Association of Northern Calif., San Francisco, CA
Charter Educational Alternatives Inc., Shutesbury, MA
Chattanooga Basketball Foundation Inc., Chattanooga, TN
Chattanooga Hamilton County Neighborhood Network, Chattanooga, TN
Chattanooga Youth Corp., Chattanooga, TN
CHBR League Inc., Gibbsboro, NJ
Cheer-Dance America Inc., Lynn, MA
Cherish Us Inc., Englewood, NH
Chernobyl Childrens Foundation Inc., Brooklyn, NY
Cherokee Heights Resident Management Council Inc., Pryor, OK
Chesapeake and Albemarle Railroad Historical Society, Virginia Beach, VA
Chesapeake Christian Marine Foundation Inc., Baltimore, MD
Chesapeake Research Institute Inc., Columbia, MD
Cheshire Interfaith Housing Inc., Cheshire, CT
Chester AIDS Coalition, Chester, PA
Chester High School Band Booster Club, Chester, SC
Chevra Kadisha of Providence & Vicinity, Providence, RI
Cheyenne Indian Center, Cheyenne, WY
Chicago Area Retinoblastoma Support Group, Harlingen, TX
Chicago Bacchanal Carnaval Inc., Chicago, IL
Chicago Institute of Holistic Medicine, Chicago, IL
Chicago-Metro Bassmasters, Chicago, IL
Chickamauga Historical Memorial Trust Inc., Chickamauga, GA
Child Abduction Prevention Services Inc., Pahrump, NV
Child First United Inc., Plano, TX
Child Placement Professionals Inc., Ada, OH
Child Reach Foundation Inc., Dallas, TX
Child Support Recovery Foundation, Mesa, AZ

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

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## Long-Term Capital Gain Treatment for Fiscal Year 1997–98 Individuals, Estates, Partnerships, and S Corporations

### Announcement 99–11

The Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105–206) amended section 1(h) of the Internal Revenue Code to modify the holding period for certain long-term capital gains. For sales, exchanges, etc., after December 31, 1997, property held more than 1 year (instead of more than 18 months) generally is eligible for the 10%, 20%, and 25% capital gains rates. The 28% rate will now apply only to the pre-1998 gains, collectibles gains, and part or all of the gain from the sale or exchange of qualified small business stock.

The 1997 Schedules D and instructions used by 1997-98 fiscal year filers do not reflect the modified holding period for certain long-term capital gains. Therefore, fiscal year filers of the 1997 Schedule D for Forms 1040, 1041, 1065, and 1120S (individuals, estates, partnerships, and S corporations) should prepare that schedule as if the second bulleted item in the footnote following Part II of Schedule D were:

- **After** July 28, 1997, and **before January 1, 1998,** for assets held more than 1 year but **not** more than 18 months.

Instead of:

- **After** July 28, 1997, for assets held more than 1 year but **not** more than 18 months.

Fiscal year filers who have already filed a 1997–98 fiscal year return may need to file an amended return for that year to reflect this change in law.

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## Announcement 99–12

This announcement reflects information to be corrected in Rev. Proc. 98–44, 1998–32 I.R.B. (8/98), reprinted as Publication 1187, which describes the specifications for filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically or Electronically.

A. Part B, Section 4.08(b) and Part E, Section 2.03(c)(2) incorrectly states the acceptable sizes of Quarter Inch Cartridges (QIC). **Quarter Inch Cartridges with a size of QIC-11 or QIC-1350 are not acceptable.**

B. Part B, Section 5.01(b)(2), incorrectly stated the save command for 5 ¼" diskettes recorded using EBCDIC on an AS400 system. The correct statement should read, "The save command for AS400 is SAVS36F."

C. Part B, Section 8, the last Note: "Apply the following formula to determine U.S. Federal Tax Withheld (field positions 374–384 of the "Q" Record). All Fields below are also in the "Q" Record:"

Under Income Codes 15 and/or 16 in the formula, "=Net Income Amount (440-439)" should read "=Net Income Amount (440-4**4**9)."

## Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

## Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

*A*—Individual.
*Acq.*—Acquiescence.
*B*—Individual.
*BE*—Beneficiary.
*BK*—Bank.
*B.T.A.*—Board of Tax Appeals.
*C.*—Individual.
*C.B.*—Cumulative Bulletin.
*CFR*—Code of Federal Regulations.
*CI*—City.
*COOP*—Cooperative.
*Ct.D.*—Court Decision.
*CY*—County.
*D*—Decedent.
*DC*—Dummy Corporation.
*DE*—Donee.
*Del. Order*—Delegation Order.
*DISC*—Domestic International Sales Corporation.
*DR*—Donor.
*E*—Estate.
*EE*—Employee.
*E.O.*—Executive Order.
*ER*—Employer.
*ERISA*—Employee Retirement Income Security Act.
*EX*—Executor.
*F*—Fiduciary.
*FC*—Foreign Country.
*FICA*—Federal Insurance Contribution Act.
*FISC*—Foreign International Sales Company.
*FPH*—Foreign Personal Holding Company.
*F.R.*—Federal Register.
*FUTA*—Federal Unemployment Tax Act.
*FX*—Foreign Corporation.
*G.C.M.*—Chief Counsel's Memorandum.
*GE*—Grantee.
*GP*—General Partner.
*GR*—Grantor.
*IC*—Insurance Company.
*I.R.B.*—Internal Revenue Bulletin.
*LE*—Lessee.
*LP*—Limited Partner.
*LR*—Lessor.
*M*—Minor.
*Nonacq.*—Nonacquiescence.
*O*—Organization.
*P*—Parent Corporation.
*PHC*—Personal Holding Company.
*PO*—Possession of the U.S.
*PR*—Partner.
*PRS*—Partnership.
*PTE*—Prohibited Transaction Exemption.
*Pub. L.*—Public Law.
*REIT*—Real Estate Investment Trust.
*Rev. Proc.*—Revenue Procedure.
*Rev. Proc.*.—Revenue Ruling.
*S*—Subsidiary.
*S.P.R.*—Statements of Procedral Rules.
*Stat.*—Statutes at Large.
*T*—Target Corporation.
*T.C.*—Tax Court.
*T.D.*—Treasury Decision.
*TFE*—Transferee.
*TFR*—Transferor.
*T.I.R.*—Technical Information Release.
*TP*—Taxpayer.
*TR*—Trust.
*TT*—Trustee.
*U.S.C.*—United States Code.
*X*—Corporation.
*Y*—Corporation.
*Z*—Corporation.

## Numerical Finding List[1]

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 1998–1 through 1998–52 will be found in Internal Revenue Bulletin 1999–1, dated January 4, 1999.

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[1] A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1998–1 through 1998–52 will be found in Internal Revenue Bulletin 1999–1, dated January 4, 1999.

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Key to Abbreviations:

| | |
|---|---|
| RR | Revenue Ruling |
| RP | Revenue Procedure |
| TD | Treasury Decision |
| CD | Court Decision |
| PL | Public Law |
| EO | Executive Order |
| DO | Delegation Order |
| TDO | Treasury Department Order |
| TC | Tax Convention |
| SPR | Statement of Procedural Rules |
| PTE | Prohibited Transaction Exemption |

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